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A Comparative Survey on Islamic *Riba* and Western Usury¹

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1 - Introduction

This article proposes to discuss the theme of usury taking into account various points of view and traditions, in particular Western and Islamic ones, in order to outline the constituent features of this phenomenon today as well as throughout its historical evolution, with the intent to offer a different perspective on the subject matter.

The following work is divided in two main parts: the former offers a brief historical overview of the major theories belonging to Western tradition regarding usury and interest and their development through the centuries, till their decline and their substitution with a modern vision of the problem. While, the latter deals with the Islamic tradition and the related concept of *riba*.

In particular, the first section follows the evolution of the concept of usury since ancient times (the Old Testament), including reference to Roman law and, then, to the Scholastic theory, followed by the influence held by Protestantism and, afterwards, by Jusnaturalism, to gradually reach the advent of capitalism and, eventually, its final outcome within the 19th and 20th century common law systems, in particular in the United States.

The second section introduces the concept of *riba* and explains its historical and cultural background, constituting the natural premise of the sixth, seventh, eighth and ninth sections, which address the recent openings

¹ Article peer reviewed.



of some Islamic communities and list the solutions adopted by the Islamic finance to overcome the *riba* prohibition.

The final sections try to compare the development of the two different traditions analyzed in light of their recent outcomes, underlying differences and similarities from a critical perspective, and proposing some brief, attempted, conclusions on the matter.

2 - Premise

The proscription of usury was the binding rule of the Islamic banking institutions of the origins². Such rule seemed to prevent Islamic banking institutions from performing banking activities in legal contexts such as the European framework³.

Nowadays, Islam remains the only main religion prohibiting any form of interest, yet this distinctiveness was not always the case. All the Abrahamic religions condemned usury and severe restrictions related to usury had been in force over about 1400 years. Generally, at the beginning, any taking of interest was condemned; but with the passing of the time, only exorbitant rates were deemed illegal and this is the kind of regulation still in force in many Western countries⁴.

Nevertheless, there are clear similarities in the spirit of Judaism, Christianity and Islam on economic matters since they emphasize justice through just wages and fair prices, condemn speculation and wasteful consumption, and advocate moral behavior in commerce⁵. As a consequence, as far as the ideas of *interest* and *usury* are concerned, it is important to say that Judaism, Christianity and Islam have always considered that

“the lender, by definition, possessed a store of capital that exceeded his requirements, while the borrower lacked the resources to satisfy his immediate needs. It would thus be unfair and even immoral for a needy borrower both to repay the capital and to increase the lender’s

² F.M. Khan, M. Porzio (edited by), *Islamic Banking and Finance in the European Union. A Challenge*, Edward Elgar, Cheltenham, 2010, p. 11.

³ F.M. Khan, M. Porzio (edited by), *Islamic Banking*, cit., p. 11.

⁴ M.K. LEVIS, *Comparing Islamic and Christian attitudes to usury*, in *Handbook of Islamic Banking*, edited by M.K. Levis e K. Hassan, Edward Elgar, Cheltenham, 2001, p. 64.

⁵ I. WARDE, *Islamic Finance in the Global Economy*, Edinburgh University Press, Edinburgh, 2014, p. 61.



wealth still further by paying him interest, especially since the additional amount must be taken from the fruit of the borrower's industry"⁶.

The concept of usury has been food for thought since ancient times. Therefore, in order to outline its fundamental features and understandings according to the evolution of Western tradition, as well as its similarities with the concept of *riba* within the Islamic World, it is necessary to address it from a historical perspective.

Hence, the following overview describes the major historical turning points in Western economic and social development.

3 - Ancient history

To begin with, it is worth saying that the three major Abrahamic religions (Judaism, Christianity and Islam) initially shared a common prohibition on usury. References to such forbidden practice can be found both in the Old Testament (in the Pentateuch, the Law of Moses, and in the Psalms) as well as in the New Testament (Luke 19: 12-27 and Matthew 25: 14-30⁷) of the Bible, wherein the ban on usury or, in other words, on lending at interest, is uncontroversial and involves an abuse of the weakened (procedural injustice) coupled with an actual violation of justice (substantive injustice) which ought to be punished⁸.

⁶ I. WARDE, *Islamic Finance*, cit., p. 61.

⁷ «14. Again, it will be like a man going on a journey, who called his servants and entrusted his wealth to them. 15. To one he gave five bags of gold, to another two bags, and to another one bag, each according to his ability. Then he went on his journey. 19. After a long time the master of those servants returned and settled accounts with them. 24. Then the man who had received one bag of gold came. "Master" he said, "I knew that you are a hard man, harvesting where you have not sown and gathering where you have not scattered seed. 25. So I was afraid and went out and hid your gold in the ground. See, here is what belongs to you". 26. His master replied, "You wicked, lazy servant! So you knew that I harvest where I have not sown and gather where I have not scattered seed? 27. Well then, you should have put my money on deposit with the bankers, so that when I returned I would have received it back with interest"» (MATTHEW, 25, v. 14-30, New International Version).

⁸ The notion of procedural injustice concerns the unlawfulness of the proceedings in settling a dispute or of the procedures or methods applied in accomplishing a specific activity. From a legal point of view, it resembles the modern notion of due process. For example, according to this concept, lending at interest to a poor implies an unfair transaction, which is based on one party taking advantage of the other party's weakness. This action can be seen also as a matter of substantive injustice, namely a violation of the



Noteworthy is that such prohibition was linked to consumption loans and poverty, and it regarded any forms of loan (so, including also goods given for profit) not just money, though, it concerned only the practice of lending at interest to *brothers*, while charging interest to *foreigners* was acceptable (this attitude was also shared both by Jewish and Islamic communities)⁹.

This early approach to usury laid down the basis for Western forbiddance of lending at interest throughout 1200 years, as two fundamental notions emerged from it: the principle of commutative justice and that of distributive justice. According to the former, usury is a sin of individual injustice (an injustice committed in dealing with another individual, such as stealing)¹⁰.

law applicable to the merit of the case.

⁹ **M.K. LEVIS**, *Comparing Islamic*, cit., p. 65. See also **A.M. EL GOUSI**, *Riba Islamic Law and Interest*, Ann Arbor University Microfilms, Ann Arbor, 1985, pp. 112-113, who affirms that usury occurs every time something more is returned regardless of its nature. This Author gives some examples: i) it is usury if the lender lives in his debtor house for free; ii) it is preceding usury if one borrows money from another and sends him a present for this loan; iii) it is succeeding usury if a one keeps the money of his neighbor for a certain period and in giving it back he also gifts a present deeming it a compensation for having the money in that period; iv) on the same ground, one cannot say to his neighbor to help him in weeding and in exchange he will help the other in digging, or vice versa, neither it is possible to ask the same work in sunny time promising in exchange the same kind of cooperation in a different season since the performances are more severe in one case than in the other; v) it is usurious also asking for a loan in exchange for information. In addition, the prohibition of usury is present also in the Hindu religion, which it is applied the *damdupat*, namely the rule against lending at interest (**A. GAMBARO, R. SACCO**, *Sistemi giuridici comparati*, Utet, Torino, 1996, p. 492).

¹⁰ **A.M. EL GOUSI**, *Riba Islamic*, cit., p. 111. The exception of lending at usury to a stranger or enemy is consistent with this understanding. **B.N. NELSON**, *The Idea of Usury: From Tribal Brotherhood to Universal brotherhood*, University of Chicago Press, Chicago, 1989, argues that much of the history of the usury theory in the West can be understood in the light of changing ideas of universal brotherhood. **M.A. KHAN**, *Methodology for Theory Building in Islamic Economics*, in *Journal of Islamic Economics, Banking and Finance*, n. 10/2014, pp. 11-37, and **P. ABEDIFAR** *Lending, the Poor and Islamic Scripture: Islamic Finance versus Welfare Islam*, available at <http://www.ssrn.com/abstract=2687658> (last visited 21 February 2018). **M.L. RIENZI**, *God and the Profits: Is There Religious Liberty for Money-makers?*, in *George Mason Law Review*, n. 20/2013, pp. 59-61, elucidates as follow: «Religion and business have been closely intertwined throughout the American experience. The original corporate charter for the Virginia Company in 1606 addressed both commercial matters like the granting of mining rights, and religious matters like the propagation of the Christian faith. Puritan merchants in New England started each new ledger with the inscription: "In the name of God and profit". So long as God came first in their lives and businesses, they saw nothing wrong with pursuing financial success. Over the centuries, the nation's religious



Whereas, with regard to the latter, usury is unjust in its redistribution of wealth as it injures the poor. It follows that the protection of the poor was the greatest need, and, accordingly, each breach thereof had to be punished.

4 - Roman law

The legal view and condemnation of usury established in the Old Testament was mirrored in Roman law alike.

Among the categories of lawful loan transactions, the Romans distinguished between *mutuum* and *commodatum*. The former, was a free of charge contract, which concerned the transfer of the ownership of consumable goods coupled with the requirement to later return the same quantity and type of goods borrowed. While, *commodatum* was the lending, for the borrower's use, of non-consumable goods coupled with an obligation to return those identical goods.

The distinguishing characteristic of a *mutuum* was that the thing involved became owned¹¹ by the borrower (since in order to consume it one

diversity has increased. The United States is now home to many different religious traditions and many different religious views on moneymaking. Some groups profess God wants them to be fabulously wealthy, while others seek God by adopting a life of poverty. In a religiously pluralistic society, such a diversity of views on religion and moneymaking is hardly surprising».

¹¹ The lender loses any interest ownership in the money provided for a *mutuum*. See J.T. NOONAN, *The Scholastic Analysis of Usury*, Harvard University Press, Cambridge, 1957, p. 135.



had to own it)¹² and *ii*) the only permissible promise was to return the equivalent value¹³ (not the identical object)¹⁴.

Due to the importance of trading activities, Romans devised, along with the possibility of single transactions, a wider contractual relation, namely partnerships, or *societas*, in which the partners combined their resources (such as money, property, expertise or labour, or a combination of them) in pursuance of common goals¹⁵.

Under Roman law, partners were allowed to allocate the partnership's profits and losses among themselves, though a single partner could not be allotted neither all losses nor all gains.¹⁶ In the event the partnership's assets were lost, a partner could not recover his investment and hoped for gain from the personal assets of the other partner.¹⁷ Such restriction on recovery distinguished partnerships from loans, as a partner retained an ownership interest in his contribution to the partnership since he bore the risk of its loss. However, *societates*, in their original form, were not sufficient to bypass the ban on usury, therefore, the Romans implemented further legal fictions so as to cloak those activities which actually involved lending at interest.

¹² **B.M. McCALL**, *Unprofitable Lending: Modern Credit Regulation and the Lost Theory of Usury*, in *Cardozo Law Review*, n. 30/2008, p. 561 ff. (since a *commodatum* and *locatio conductio rei* required the return of the identical object, the ownership, which involves the ability to dispose of or consume the good, was not transferred to the borrower).

¹³ Art. 1803 of the Italian Civil Code defines a *comodato* as a contract by means of which one party delivers to the other party a movable or immovable property so as the recipient could use it for a specific purpose or length of time, though being required to return the property received. The *comodato* is essentially gratuitous. Hence, in case of a compensation for the lending of the property the *causa* of the contract would change and the latter would be regarded as a rent contract which implies also a change in the regulation of the latter. The Italian Corte di Cassazione has issued two judgments in this regard. The first judgment (Corte di Cassazione, jud. n. 4190 of 1980) sets that if the remuneration for the lending of the property is precarious and is aimed only at its custody, then a tenancy at will arises, rather than a rent contract. Accordingly, the second judgment establishes that the tenancy at will implies a lending of an immovable property which is temporary, revocable and focused on the custody of the property itself, and that differs from the *comodato* in the presence of a remuneration (Corte di Cassazione, jud. n. 6164 of 1986).

¹⁴ **B.W. DEMPSEY**, *Interest and Usury*, Dennis Dobson, London, 1948, p. 143.

¹⁵ See **H. HANSMANN, R. KRAAKMAN, R. SQUIRE**, *Law and the Rise of the Firm*, in *Harvard Law Review*, n. 119/2006, pp. 1335-1403.

¹⁶ See **R. ZIMMERMANN**, *The Law of Obligations: Roman Foundations of the Civilian Tradition*, Oxford University Press, New York, 1996, pp. 458-59: an agreement where one partner bore only loss and no gain was referred to as a *societas leonine*.

¹⁷ See **J.T. NOONAN**, *The Scholastic Analysis*, cit., p. 134.



In particular, the *contractus trinus*, or triple contract, stood as the most significant development of the early partnerships' framework. In fact, this contract included two further agreements in addition to the one founding the partnership: one allowed a partner to exchange the share of future gains deriving from the partnership for a fixed amount of guaranteed profit, and, the other enabled the second partner to return the first partner's capital in exchange for a further reduction of the agreed guaranteed profit¹⁸. Hence, triple contracts were deemed lawful as they were based on the same principle underlying *societas*, i.e. the freedom of partners to allocate future profits among them, coupled with the presence of the risk of loss which, accordingly, justified the purchase of an insurance against it.

Moreover, along with the *contractus trinus*, additional forms of transactions were conceived so as to cover the presence of lending at interest under different labels, such as *foenus nauticum* and *depositum*. These could be considered likewise alterations of the original pattern of *societas*.

A *foenus nauticum* involved an investor lending goods or money to a seafaring merchant¹⁹; in the event the ship was lost during the journey, the merchant was not required to repay the amount invested²⁰. On the contrary, if the voyage was successful, the merchant had to return the goods loaned and provide also the agreed-upon percentage of the expected profits which would derive from the subsequent sale of such goods²¹. The validity of *foenus nauticum* and its exclusion from the category of usury rested upon its peculiar form, for it represented a limited in time, special purpose-partnership, whose aim was to invest in trading on dangerous sea-journeys; this contractual relation shared with *societas* the contribution of assets or money on the part of an investor, who retained, to some extent, ownership on them, while bearing the risk of lose his investment²².

The *depositum* mirrored today's deposit accounts, at least in form, as it regarded the agreement between a depositor, who entrusted his goods to a merchant²³, who would subsequently return him the corresponding amount of money. This transaction implied a passive role of the investor, who would invest in alleged fruitful ventures, bearing the risk, however, that such commercial activities could be also unsuccessful and could,

¹⁸ J.T. NOONAN, *The Scholastic Analysis*, cit., p. 209.

¹⁹ J.T. NOONAN, *The Scholastic Analysis*, cit., pp. 134-135.

²⁰ J.T. NOONAN, *The Scholastic Analysis*, cit., pp. 134-135.

²¹ J.T. NOONAN, *The Scholastic Analysis*, cit., pp. 134-135.

²² B.M. McCALL, *Unprofitable Lending*, cit., pp. 573-574.

²³ B.M. McCALL, *Unprofitable Lending*, cit., pp. 171-72.



therefore, bring no profit at all. Hence, the *depositum* might be deemed a simpler type of partnership, in which the interests paid on the goods (or money) deposited depended upon the outcome of the venture, and were not defined *a priori*, as in usury loans.

5 - Aquinas and Canon law

The legal framework of contractual relationships described in the previous paragraph outlasted the end of the Roman Empire and survived largely after it, until the 13th century when Europe experienced the development of a new era, in which new towns sprang throughout its territory, and a powerful social and economic class, the merchants, arose.

Trading activities increasingly grew, so were the connections and profitable exchanges among different areas, deriving from the commercial activities carried out by merchants across local and regional boundaries.

Consequently, the protection of the poor was no longer the main purpose pursued by law and the society at large, for the most imminent problem consisted in redefining and reclassifying the commercial relationships so as to enable merchants to lawfully carry out their trading activities, while somehow preserve the forbiddance of usury²⁴, set forth in ancient times by the Romans.

The initial ban on usury established by the Canon law rested upon the legal approach provided by Roman law in this regard, and it was contained in the Papal Encyclical *Nec hoc quoque* by Saint Leo the Great (5th century), whose contents were then repeatedly reaffirmed over the centuries, until the beginning of the 1st millennium B.C. when the previous framework had to be adapted and improved so as to fit the new social and economic context. The Scholastic theory offered in this regard an additional source of arguments against usury, namely the Aristotelian philosophy. Saint Thomas Aquinas, the main Scholastic philosopher, persuaded the Church's Fathers that Aristotle's philosophy could form the basis of Christian philosophy. Hence, the definition of usury was further developed in light of the Greek philosopher's thought.

First of all, Aristotle distinguished between natural and unnatural ways of production, including in the latter the income derived from money lending, which led to considering interest a violation of natural law.

²⁴ I. WARDE, *Islamic Finance*, cit., p. 62.



Besides, Aquinas drew on Aristotle's theory of money as barren²⁵, i.e. money is used in exchange of goods, but it has no value in itself as it is a mere means²⁶, so, if an individual gains profits out of it, he does it against natural law.

Furthermore, Aristotle held that commutative justice required equality in all exchange transactions²⁷ and obtaining interests from lent-money violated this principle; in fact, as money is a medium of exchange, whose value is fixed and established *a priori*, transferring its ownership at a higher price is equal to selling something that does not exist, a behaviour which evidently leads to inequality in exchanges. And, although it is possible to charge separately for the ownership and use of certain assets (durable assets), this is not the case for money, since it is consumed in using it, as its use involves the transfer of its ownership (i.e. by spending it). So,

²⁵ J.M. KEYNES, *The General Theory of Employment, Interest and Money*, Macmillan, London, 1951, Book VI, Chapter 13 and 14, and Book VI, Chapter 23, the Author said that Locke was, perhaps, the first to express in abstract terms the relationship between the rate of interest and the quantity of money. He opposed the proposal of a maximum rate of interest on the ground that it was as impracticable as to fix a maximum rent for land, since "the natural Value of Money, as it is apt to yield such an yearly Income by Interest, depends on the whole quantity of the then passing Money of the Kingdom, in proportion to the whole Trade of the Kingdom (i.e. the general Vent of all the commodities)". Locke explains that Money has two values: 1) its value in use which is given by the rate of interest "and in this it has the Nature of Land, the Income of one being called Rent, of the other, Use", and 2) its value in exchange "and in this it has the Nature of a Commodity", its value in exchange "depending only on the Plenty or Scarcity of Money in proportion to the Plenty or Scarcity of those things and not on what Interest shall be". Thus, Locke was the parent of twin quantity theories. In the first place he held that the rate of interest depended on the proportion of the quantity of money (allowing for the velocity of circulation) to the total value of trade. In the second place he held that the value of money in exchange depended on the proportion of the quantity of money to the total volume of goods in the market.

²⁶ See ARISTOTLE, *Nicomachean Ethics*, in *The Basic Works of Aristotle*, edited by R. McKeon, Random House, New York, 1941. Chapter 5 shows a clear prevalence of the barter system: "Now proportionate return is secured by cross-conjunction. Let A be a builder, B a shoemaker, C a house, D a shoe. The builder, then, must get from the shoemaker the latter's work, and must himself give him in return his own. If, then, first there is proportionate equality of goods, and then reciprocal action takes place, the result we mention will be effected. If not, the bargain is not equal, and does not hold; for there is nothing to prevent the work of the one being better than that of the other; they must therefore be equated. (And this is true of the other arts also; for they would have been destroyed if what the patient suffered had not been just what the agent did, and of the same amount and kind.) For it is not two doctors that associate for exchange, but a doctor and a farmer, or in general people who are different and unequal; but these must be equated".

²⁷ ARISTOTLE, *Nicomachean Ethics*, cit., par. 1131b32-1132a7 and par. 1132a14-19.



use and ownership of money cannot be transferred separately and hence cannot be charged for separately²⁸.

From such basis, Aquinas and the Scholastic philosophers derived three basic arguments against the practice of usury: i) money is not a productive asset; ii) money is a fixed medium of exchange and can only be sold for its fixed price; iii) the ownership of money means nothing but the right to use it in order to buy goods, it followed that it would not be possible to separately charge for the use and the ownership of money.

Moreover, the additional ground for the prohibition of usury, which was introduced by the medieval Church, concerned time²⁹ and it lay on the assumption that charging an interest (namely gaining a higher amount of money than the one previously lent) on the lapse of time required by the borrower to redeem the loan was forbidden for time belonged to God³⁰.

Notwithstanding those new arguments in favour of the prohibition of usury, in the 13th century Canon Law strove to find a way to legitimize to certain extent the lawfulness of lending at interest. Scholastic philosophers drew a distinction of a great importance to merchants: though money in itself bore no fruit, or in other words, it did not bring new wealth, the asset(s) purchased with that money along with the labour of the

²⁸ B.M. McCALL, *Unprofitable Lending*, cit., p. 565.

²⁹ Interest represented a payment for the passage of time. «Under Charle Magne, who first extended the usury laws to the laity, usury was defined in 806 c.e. as "where more is asked than is given", while in the 13th century usury or profit on a loan (*mutuum*) was distinct from other contracting arrangements. A usurer, in fact, was anyone who allowed for an element of time in a transaction, such as by asking for a higher price when selling on credit or, because of the lapse of time, goods both cheaper and sold dearer. The sin was in exploiting time itself. Time belongs to God a divine possession. Usurers were selling something that did not belong to them. They were robbers of time, medieval gangsters» (quotation omitted). M.K. LEVIS, *Comparing Islamic*, cit., p. 69. See, A. BUCCI, *La formazione dell'istituto giuridico dell'usura nella Chiesa latina nel XIII secolo*, in *Stato, Chiese e pluralismo confessionale*, April 2010, available at www.statoechiese.it (last visited 21 January 2019), for a complete overview on the medieval time usury emersion, in particular for the expert of the Decreti of that historical and juridical era.

³⁰ Such arguments against usury resemble in part those on which the Islamic prohibition of *riba* is based, in particular the one concerning time, in fact (see E. RICHARDSON, *The Shari'ah Prohibition of Interest*, in *Trinity College Law Review*, n. 11/2008, pp. 78-87. Islamic scholars regarded time as a gift from *Allah* which cannot, therefore, be valued in economic terms. However some striking differences appear between the Islamic and Catholic stance in this regard, such as i) the fact that the Qu'ran prohibition of usury is straight and ii) the principles stated therein cannot be adapted to the newly arising circumstances as the former are as immutable as God, and, iii) as opposed to the Bible, the Qu'ran openly endorses trade and commerce, provided that no usury transactions take place.



merchant were deemed to generate new wealth instead. Moreover, Canon Law recognized, at least implicitly, that the use of money to acquire goods or services to commence or expand a business was fundamentally different from the use of money to buy consumable goods.

As a result, Scholastics identified, on the basis of Roman law, two main categories of transactions in which lending at interest was acceptable.

First, the idea of interest (*interesse*) was considered licit in case it arose from any detriment suffered by lending. A creditor could, indeed, demand a compensation (*damna et interesse*) for the damage caused to him by the debtor, as a result of the latter's default or delay in the repayment of the principal, corresponding to any loss incurred or gain forgone on the creditor's part. Moreover, the payment could also be demanded under the doctrine relating to *lucrum cessans*: the Scholastic legal theory preserved the Roman legal concept of *quod interest*, or the difference, which is essentially the modern concept of expectation damages (including lost profits).³¹ Interest was never thought of as a payment on a loan, but as the *difference* to be made up to a party injured by the failure of another to execute his obligations, hence interest was purely compensatory. However, such provisions opened the door to the taking of interest.

Second, several transactions mirroring loans were concealed under different labels, consequently acquiring a lawful status. Those transactions were in part of Roman origin, though adapted to the changes in society's needs, such as *societas* and *depositum*³², as well as new dealings such as government bonds³³ and future sales.

As regards government bonds, or *mons*, these were peculiar types of transactions which concerned Italian city-states, which had the right to conscript money from their citizens in order to finance public policies; those compulsory loans were subsequently returned to citizens and, in some cases, governments may also have paid them an annual gratuity. Those transactions were not considered usury according to the scholastics, because they fell under the state power of taxation, therefore, they were not definable as voluntary forms of usury.

³¹ See J.T. NOONAN, *The Scholastic Analysis*, cit., pp. 105-106.

³² See MODESTINUS, *Digesto*, par. 22, n. 2.1, in *Encyclopaedia*, p. 10. It was similar to a modern deposit account; the depositor placed goods - later money - by a merchant who would have returned the same amount deposited if he did not make any use of the money. The merchant would have returned what deposited plus a portion of his profits if he used the money in his own business. The payment to the depositor is related to the use of the money left into custody, so there cannot be usury.

³³ MODESTINUS, *Digesto*, par. 22, n. 2.1, in *Encyclopaedia*, p. 10.



In the case of future sales, instead, they consisted especially in bills of exchange, namely in the sale of an obligation to pay an amount of money in a different currency sometimes in the future. However, the usurious nature of this transaction was covered by the initial price of sale, which already involved an interest on the amount and a charge, a fee, for the conversion of the currency.

The justification of these transactions arose from a fundamental tenet of the Scholastic theory, according to which, if a person lends money, its ownership is transferred to the borrower, which holds that money at his own risk, preventing the former from exacting more; while, on the other hand, if the lender entrusts his money to a merchant or craftsman so as to form a kind of society (partnership), he does not transfer the ownership of that money to them; consequently, if the merchant speculates with it at the lender's risk, or the craftsman uses it, the lender would be entitled to demand, as something still belonging to him, part of the profits derived from that money. So, a partner was seen as retaining an ownership interest in his contribution to the partnership since he bore the risk of a possible loss in the venture.

Therefore, the underlying feature shared by these different forms of transactions, which excluded them from the prohibition of lending at interest, lay in the risk-sharing attitude of the parties involved.

6 - 16th Century: Protestantism and the mercantile era

The influence of the Scholastic Theory in the field of economic matters lasted until the 16th Century, when Western society entered the mercantile era. In this period, commerce expanded throughout Europe and the Church was no longer at the centre of the economic life, as new and uncontrolled markets arose; this led, eventually, to the necessity to adapt (once again) the Scholastic theory of usury to the changes in the economic context³⁴.

Prior to the 16th century, the request for capital and its uses were so limited that it was reasonable to assume that one acquiring money needed it for consumption, not for production. But in the 16th century the demand for investments in business ventures spiraling increased owing to the

³⁴ J.T. NOONAN, *The Scholastic Analysis*, cit., p. 199 ("Europe was undergoing a commercial revolution in many ways no less far-reaching in economic consequences than the Industrial Revolution of the late eighteenth and nineteenth centuries").



geographic discoveries of America and the Far East as well as the resulting high-risk trading and colonization ventures³⁵.

In the meanwhile, the Church had not only to face the challenges brought about by the new economic reality, but also by the rise and spread of Protestantism, mostly represented by Martin Luther and Calvin, whose groundbreaking interpretations of economics and more specifically of the concept of usury concurred in the transformation of Europe.

In order to meet those emerging needs, in the first half of the 16th century, the Church approved the payment of *lucrum cessans* to depositors in a *mons pietatis*³⁶. Initially, these institutions were funded by charitable donations and had been established to lend money to the poor to fund necessary consumption without applying any interest rate. Nonetheless, in order to increase the scope of their philanthropic work, the *mons* eventually consented to take cash deposits and accordingly pay *lucrum cessans* ranging from 4% to 6%.

As a natural consequence of this evolution, once lending at interest became an accepted practice throughout Europe, *Montes Pietas* abandoned their charitable role³⁷.

Pope Paul III recognized that those who could use money to make a profit but diverted these funds to assist the poor, were not acting unjustly in asking for some compensation for their loss³⁸, as the lending of money to fund necessary consumption could create a loss to the lender equal to the guaranteed (or safe) investment in the available businesses at the time.

In so doing, the Scholastic theory by the 17th century had developed a methodology that could be applied to the new complex economic reality

³⁵ N.D. RAY, *The Medieval Islamic System of Credit and Banking: Legal and Historical Considerations*, in *Arab Law Quarterly*, n. 12/1997, p. 80. There are other economic reasons in the medieval Islamic which militated against the formation of large concentrations of capital. These were: 1) The general unimportance of interest lending, which favors the accumulation of capital by sheltering it from risk, and the concomitant dependence on partnership and *commenda* investments, which, on the contrary, must have exerted a negative influence on capital formation by subjecting capital to risk. 2) The impossibility of the insurance contract in the Islamic economic system.

³⁶ *Mons Pietas* can be translated as mountain of piety.

³⁷ Though *Montes Pietas* started to charge interest rates, they were so low that these institutions were not able to expand within the new economic and financial context of the following centuries.

³⁸ See J.T. NOONAN, *The Scholastic Analysis*, cit.; Pope Paul III's decision was affirmed by two of his successors as well as the Council of Trent.



as it permitted some kind of investments in business and income-producing assets, as well as in low profit activities³⁹.

However, as stated above, the amendments to the original Scholastic theory of usury were not the only available solution to face the economic changes of the 16th century. An additional theory emerged together with the Protestant reformation.

According to Martin Luther⁴⁰ (1483-1546) money had to be taken as a payment for the delay beyond a stipulated time and it could be a fair payment for actual damage or injury deriving from this delay. Furthermore, Luther traced a distinction, starting from the observation that if income is bought without assuming risks and troubles, and in so doing the buyer stands no possibility to lose more than he has invested, then, it is clear that such trading operation cannot imply any interest owing to the fact that there is no risk at stake. Therefore, money in trade and money at interest cannot be considered the same, as investing money in trade has no certain outcome and the interest which may be obtained is accidental, while the interest gained from money invested in income is something constant and profitable, hence, they do not share the same degree of risk.

Whereas, Calvin (1509-1564) denied that the payment for the use of money was a sin *per se*⁴¹, as no direct prohibition of usury was to be found in the Holy Scriptures, so that they should be interpreted in light of individual conscience, the society needs and the saying "do unto others as you would have them do unto you".

Calvin affirmed therefore that the burden of usury was to be imposed on the conscience of the lender. Obviously, such freedom was to be limited, as he asserted that "usury is not wholly forbidden among us unless it be repugnant both to Justice and to Charity"⁴².

³⁹ According to the Church legitimization of those new applications of the usury theory, only in case of a loan (*mutuum*), the charging of any interest was still considered illicit, whereas, obtaining gains from other types of contracts or transactions was then deemed acceptable.

⁴⁰ **M. LUTHER** addressed the issue of usury in his work, *On Trading and Usury*, in *Works of Martin Luther with introductions and notes*, edited by H.E. Jacobs, A. Spaeth, A.J. Holman, Philadelphia, 1915, vol. 4.

⁴¹ **M.K. LEVIS**, *Comparing Islamic*, cit., p. 77, according to whom this is the foundation of the spirit of capitalism.

⁴² **C. ELLIOT**, *Usury: a Scriptural, Ethical and Economic View*, available at <http://readcentral.com/SmartReader/Calvin-Elliott/Usury-A-Scriptural-Ethical-and-Economic-View/> 012 (last visited 2 March 2018).



This interpretation of usury reflects the entire idea underlying Calvinism, namely the direct relationship between man and God which results in his daily achievements and religious fulfillment, deriving from his hard work and not only from prayers and spiritual contemplation.

Thus, Calvin continues

“the profit does not arise from the money, but from the product that results from its use or employment. I therefore conclude that usury must be judged, not by a particular passage of Scripture, but simply by the rules of equity”⁴³.

Usury can be considered licit, but only in some cases, namely usury is sinful only if it hurts one's neighbor, “and charity and natural equity alone can decide in what particular cases a charge for a loan does hurt a neighbor since each believer is guided by his own conscience”⁴⁴.

Hence, according to Calvin Reformation the lender is not a sinner, but on the contrary he plays an essential role within the society; in fact, when an individual voluntarily deprives himself of his money, by means of which commercial activities are financed as well as job opportunities are created, then such lending is considered licit, as long as the interests charged are reasonable and do not oppress the debtor.

Such view was largely welcomed at that time in Europe and many protestant States embraced it, consequently dropping the legal prohibition on usury. For example, in 1545, after the Anglican schism, a statute was enacted in England, legalizing interest but limiting it to a legal maximum of 10%, and legislation laying down a maximum rate in place of a prohibition of interest was made permanent by law in 1571. Such usury laws became the norm thereafter in Protestant Europe.

7 - 17th century: Jusnaturalism

⁴³ C. ELLIOT, *Usury: a Scriptural*, cit. This can be clarified by an example. Let us imagine a rich man with large possessions in farms and rents, but with little money. Another man who is not so rich, nor has such large possessions, has however more ready money. The latter being about to buy a farm with his own money, is asked by the wealthier for a loan. The lender may stipulate a rent or interest on his money and also that the farm may be the mortgage collateral until the principal will be paid, but until its payment, the lender will be content with the interest or usury on the loan. Why then shall this contract implying a mortgage (only for the profit of the money lent) be condemned, when a much harsher, it may be, of leasing or renting a farm at large annual rent, is approved?

⁴⁴ I. WARDE, *Islamic Finance*, cit., p. 63.



After the spread of the Protestant view on usury, in the 17th century a further change of perspective was brought about by Jusnaturalism in this regard.

One of the most influential legal scholar of such school of thought, Hugo Grotius (1583-1645) not only opposed the Aristotelian/Scholastic idea of the unfruitful nature of money, but also affirmed that if the compensation allowed by law did not exceed the proportion of the inconvenience on seller and buyer sides, its allowance was neither repugnant to the revealed law, nor to natural law: but, if it did exceed those bounds, then it was deemed an oppressive sale⁴⁵. The justice and reasonableness of such regulations had, indeed, to be measured by the hazard or the inconvenience of lending, for if the reward exceeded such conditions, then it became an act of extortion or oppression, otherwise it was deemed acceptable⁴⁶.

Samuel von Pufendorf (1632-1694), the other great theorist of this doctrine, stated that it was unreasonable that one person lent money to a borrower who made profit from it, whereas the lender could not take any advantage out of it. Moreover, he, like Grotius, denied the traditional Scholastic approach about money infertility in itself, asserting that money held a value even though it was a fictitious creation of men in order to avail themselves of the chance to comfortably trade goods and services⁴⁷.

Whereas, in line with the evolution of the Scholastic theory of usury, which took place through the 16th and 17th centuries, Jusnaturalism recognized that demanding more than it was given was to be considered as

⁴⁵ Grotius says that the price of a good tends to be established by the value a community tend to offer for it; however, such price is not fixed but “is wont to change suddenly according to the abundance or scarcity of buyers, of money and of commodities”. Moreover, other specific circumstances may arise, such as an expected loss, absence of profit, personal fancy, or sale or purchase, as a favor to another “[and] the loss or absence of gain which arises from deferred or anticipated payments”, that may lead to a lower or a higher price than the usual one. Hence, the charge of interest or a compensation are deemed lawful, provided that the seller and the buyer are aware of such exceptional circumstances which influence the sale. See **H. GROTIUS**, *De Iure Belli ac Pacis*, Book II, Chapter XII, Paragraphs XIV-XXIII, available translated in English at <https://www.lonang.com/library/reference/grotius-law-war-and-peace/> (last visited 1 March 2018). See also **H. GROTIUS**, *On The Law of War and Peace*, Book II, Chapter XII, Paragraphs XIV-XXIII, in <https://www.lonang.com/library/reference/grotius-law-war-and-peace/> (last visited 11 March 2014).

⁴⁶ **H. GROTIUS**, *De Iure Belli*, cit., Chapter XXI.

⁴⁷ **S. VON PUFENDORF**, *De Iure Naturae et Gentium Libri Octo*, Book VII, Paragraphs XIII.



unfair as receiving less than the amount lent. Hence, on the premise that a lender suffered a loss, because throughout the loan period he was prevented from using his own money to make a profit, lending at interest started to be considered admissible. This stance reflected the Scholastic idea that interest was deemed licit only in case it represented a compensation for a loss⁴⁸.

8 - 18th century and 19th centuries: industrialization and capitalism

During the 18th century, Europe witnessed another great economic and social transformation, as industrialization and the capitalist ideology gained ground, especially in England. Money started to be considered a commodity equal to any other goods, which consequently led to a redefinition of the notion of usury.

Jeremy Bentham (1738-1832) supported the practice of usury, describing it as "the liberty of making one's own terms in money bargains"⁴⁹. He proposed also two possible meanings of usury: i) the political or legal one, namely, the taking of a greater interest than the law allows for and, ii) the moral or social one, i.e. the taking of a greater interest than the one acknowledged by the community⁵⁰.

Bentham's analysis of the idea of usury is contained in a series of letters⁵¹, addressed to Adam Smith, and which aimed at defending, in general, the idea of individual and economic freedom. He saw usury as a sort of liberty which had long suffered unjust treatment and whose prohibition established by law had rather negative effects. The author's idea of usury is crystal-clear: each person should be individually and

⁴⁸ In so doing, the Scholastic theory preserved the general prohibition of usurious interest, though, on the other hand, legitimizing some trading transactions which implied lending at interest.

⁴⁹ I. WARDE, *Islamic Finance*, cit., p. 64.

⁵⁰ J. BENTHAM, *Defense of Usury*, available at http://www.econlib.org/library/Bentham/bnt_hUs1.html#LETTER, I. Introduction (last visited 1 March 2018). The Author maintains that the law should provide a clear definition of usury so as to prohibit it, and that such definition to be truly effective shall replace the moral one.

⁵¹ Those letters were collected into the work of J. BENTHAM, *Defense of Usury*, cit., first published in 1787.



economically free and should also not be called 'usurer' - which is an inappropriate name - when he takes as much as he can get.⁵²

Adam Smith (1723-1790), for his part, was extremely moderate towards usury laws. For he was well aware that individual savings may be absorbed either by investment or by debts, and that there was no certainty that they would finally find an outlet in the former. He favored therefore a low rate of interest as it increased the chance of savings finding their outlet in new investments rather than in debts.

He admitted that interest and usury were the basis on which the market worked, even if he warned the public about the fact that their interests were nearly always very different from the ones of traders and merchants, which usually aimed at obtaining their own profits.

Smith, anticipating Keynes, elaborated the following maxim, in order to sketch a general notion regarding stocks' profits (which could not be precisely determined) linking them to the variations of interest rates:

"wherever a great deal can be made by the use of money, a great deal will commonly be given for the use of it; and that wherever little can be made by it, less will commonly be given for it. According, therefore, as the usual market rate of interest varies in any country, we may be assured that the ordinary profits of stock must vary with it, must sink as it sinks, and rise as it rises"⁵³.

Hence, Smith considered the prohibition on interest a mistake, for there would always be someone in need of money who would be forced to borrow it, and if lending at interest was illegal, lenders would have surely charged a higher interest rate owing to the difficulty and danger they may have incurred by lending. So, such prohibition did not prevent the usury practice.

Therefore, lending at interest should be considered lawful, though the proportion which the usual market rate of interest ought to bear to the

⁵² C. ELLIOT, *Usury, A Scriptural, Ethical and Economic View*, Antiusury League, Millersburg, 1902, pp. 180-181, notes that usury not only enslaves the borrower and oppresses the poor who are innocent of all debts, but it also affects the rich by gathering the wealth of the wealthy into fewer and fewer hands. There is a centralizing drift that threatens and then finally absorbs the smaller fortunes into one colossal financial power. Wealth cannot be so fortified and guarded as to successfully resist the attack of a superior wealth when the practice of usury is permitted. The smaller and weaker fortune, using the same weapon as the larger and stronger one, must inevitably be defeated and overcome, and ultimately absorbed.

⁵³ A. SMITH, *An Inquiry into the Nature and Causes of the Wealth of Nations*, Methuen and Co., London, 1776, Chapter 9, p. 4.



ordinary rate of clear profit, necessarily varies as profit rises or falls.⁵⁴ Hence, lending at interest must be adequately proportionate, according to profits.

Carrying on with the analysis of conceptualisation of usury, John Keynes (1883-1946) argued that people saved money not because of the rate of interest but rather because of their level of income. He also pointed out that the main reasons for choosing to keep money in cash rather than in bonds were: *i)* the transactionary motive, i.e. the need for cash for the current transactions of personal and business exchanges; *ii)* the precautionary motive, i.e. to provide for contingencies requiring the sudden use of money and unforeseen opportunities and *iii)* the speculative motive, i.e. the object of securing profit from knowing better than the market what the future will bring forth⁵⁵.

Keynes stated that:

“there is a continuous curve relating changes in the demand for money to satisfy the speculative motive and changes in the rate of interest as given by changes in the prices of bonds and debts of various maturities”⁵⁶.

The strength of these three types of motive will partly depend on them being less expensive and on the reliability of the methods of obtaining cash - when required - by means of some form of temporary borrowing⁵⁷.

According to Keynes, the rate of interest was the price which equilibrated the demand for liquidity with its availability; hence, a lower rate of interest could stimulate an expansion of capital investments in fields in which investing at higher rates would be unprofitable⁵⁸.

⁵⁴ A. SMITH, *An Inquiry*, cit., p. 22.

⁵⁵ A.M. EL GOUSI, *Riba Islamic*, cit., p. 277, deduced that unemployment derived from the fact that capitalists do not find it efficient to invest their funds in the fields where the rate of return is less than the current rate of interest. For example, given an interest rate of 5% an investment with a rate of return of 4% for the capital employed in the production of glasses is not worthy according to the capitalist perspective and, so, unproductive. The capital in this way will remain crystallized and not employed, depriving the society of useful activities and, in first instance, of employment.

⁵⁶ J.M. KEYNES, *The General Theory*, cit., Book VI, Chapter 13, p. 27.

⁵⁷ J.M. KEYNES, *The General Theory*, cit., Book VI, Chapter 15; the Author says that further reasons are: *i)* the Income-motive. One reason for holding cash is to bridge the interval between the receipt of income and its disbursement, and *ii)* the Business-motive. Similarly, cash is held to bridge the interval between the time of incurring business costs and that of the receipt of the sale-proceeds.

⁵⁸ J.M. KEYNES, *The General Theory*, cit., Book VI, Chapter 15. In the *Appendix On The Rate Of Interest*, in Marshall's *Principles Of Economics*, Ricardo's *Principles Of Political*



Therefore, Keynes, like Smith, was in favor of a properly balanced rate of interest.

Finally, Keynes recognized a fundamental difference between capital and mere money, so he re-evaluated the distinction between the rate of interest and the marginal efficiency of capital⁵⁹ which was initially expressed by the Scholastic Theory through the difference between usury from a *mutuum* and profit derived from a true *societas* or *census*.

As Henry Sommerville observed: "The canonists' principle was that sharing in trade risks made an investor a partner, a co-owner of capital, not simply a money lender, and gave a title to profit"⁶⁰. Thus, the presence of the risk (which could only be insured against at a price, namely, foregoing larger profits) distinguished capital from mere money⁶¹.

Subsequently, the United States economic philosophy has developed parallel to the evolution of the Common Law.

Hence, after a first period of strict prohibition of usury, in the 16th century England enacted the first legislation setting the maximum interest rate. Afterwards, in 1854 usury laws were abrogated, reflecting a change of perspective towards usury and interest which was strictly connected to the historical and economic developments of the time, such as the colonization and, further on, the industrialization.

In particular, in the United States, the issue of usury resulted in two strictly connected outcomes, namely the National Bank Act (NBA) of 1863 and, at a later stage, the Marquette case⁶².

Economy and elsewhere, III, Keynes theorised a unique rate of interest called the neutral rate of interest. Such neutral rate of interest was more strictly defined as the rate of interest which prevails in equilibrium when output and employment are such that the elasticity of employment as a whole is zero (ID., *The General Theory*, cit., Book VI, Chapter 6).

⁵⁹ J.M. KEYNES, *The General Theory*, cit., pp. 351-52.

⁶⁰ H. SOMERVILLE, *Interest and Usury in a New Light*, in *The Economic Journal* n. 41/1931, p. 646.

⁶¹ B.W. DEMPSEY, *Interest and Usury*, cit., p. 3. Once this foundational distinction between money and capital is accepted, the law of usury must first and foremost distinguish between transactions where money or capital is provided. A loan can be defined for purposes of identifying transactions subject to usury law as the provision of funds for the purpose of acquiring goods or services which will be withdrawn from the market and consumed. A transaction not involving a loan and thus not subject to usury law can be defined as the provision of funds for the purpose of acquiring unfinished goods or services which will be incorporated into new goods or services for future resale at an anticipated gain. These definitions require the law to investigate the purpose of the transaction and the use of proceeds.

⁶² *Marquette Nat'l Bank v First of Omaha Serv. Corp.* was a case between a Federal Bank



The latter led in 1980 to a revolutionary federal intervention, i.e. the removal of any usury limitations upon States, which, over the decades, has given rise to serious issues, such as short-term loans (for instance, payday loans) and skyrocketing interest rates, that currently affect American consumers⁶³.

9. The prohibition of *riba*⁶⁴

At the extreme opposite of the comparatistic landscape, we find the Islamic legal system that is based on completely different legal sources compared to the ones funding the western legal tradition: primarily the Koran, Islam's holiest scripture which regulates both legal and non-legal issues, secondly the *Sunna*, a compilation of the conversations, actions, affirmations, aphorisms, characteristics and deeds attributed to the Prophet Muhammad, and thirdly the interpretations of these two written sources given by jurists of competing schools of law⁶⁵.

(First National Bank of Omaha) and a State Bank (Marquette National Bank, Minnesota), which was decided in favor of the former. This case concerned the issue of usury rates applied by a bank (a subsidiary of a Federal bank) to its clients (resident in a different State than the one where the Federal bank was headquartered), which exceeded the usury rates allowed by the State of residence of the clients (and of the subsidiary), but not the ones of the State of residence of the Federal bank. It was a matter of jurisdiction and fair competition, as well as Federal powers vs. State powers. The case, which was initially settled in favor of the State Bank, was eventually reversed by the Supreme Court, which decided in favor of the Federal bank, on the basis of two precedent judgments: *Fisher v First National Bank of Chicago* and *Fisher v First National Bank of Omaha*.

⁶³ See **A. CORBIN**, *On Contracts. A Comprehensive Treatise on the Working Rules of Contract Law*, Minnesota West Publishing, Saint Paul, 1962.

⁶⁴ **G.M. PICCINELLI**, *Il Diritto agli interessi nei Paesi Arabi*, in *Diritto del commercio internazionale: pratica internazionale e diritto interno*, n. 10/1996, pp. 35-75. For a general overview, see **J. SCHACHT**, *An introduction to Islamic Law*, Clarendon Press, Oxford, 1964, and, for a different viewpoint, **G.M. PICCINELLI**, *Il diritto musulmano e dei paesi arabo-islamici*, in *La presenza arabo-islamica nell'editoria italiana*, edited by I. Camera D'Afflitto, Ministero per i beni e le attività culturali, Ufficio centrale per i beni librari, le istituzioni culturali e l'editoria, Divisione editoria, Istituto poligrafico e Zecca dello Stato, Rome, 2000, and **S.A. ALDEEB ABU-SAHLEH**, *Interessi e sistema bancario degli Ebrei, Cristiani e Musulmani*, Centro di diritto arabo e musulmano, Saint-Sulpice, 2011.

⁶⁵ See **F. KUTTY**, *The Shari'ah Factor in International Commercial Arbitration*, in *Loyola International and Comparative Law Review*, n. 28/2006, p. 565 ff.; **H. HARASANI**, *Analysing the Islamic Prohibition on Ribā: A Prohibition on Substance or Form?*, in *Arab Law Quarterly*, n. 27/2013, pp. 289-296; **V. CATTELAN**, *From the Concept of Haqq to the Prohibitions of Ribā, Gharar and Maysir in Islamic Finance*, *International Journal of Monetary Economics and Finance*,



Thus, Islamic law is the direct manifestation of the will of God, not the expression of the political thoughts of a human lawmaker.

And because God is the source of authority and the sole sovereign lawgiver, Islamic law is immutable, and all human legislation must conform to the divine will. The *riba* forbiddance is part of it.

Indeed, this prohibition reflects a fundamental Islamic principle: accumulating wealth through interests is not a proper way of earning, because it is passive and the related increase does not result from labour and risk-taking⁶⁶.

There are no definitions of the concept of *riba* in Islamic law⁶⁷. Under *sharia*, the term “refers to the premium that must be paid by the borrower

n. 2/2009, pp. 384-397 (suggesting a juridical interpretation of the prohibitions of *riba*, *gharar* and *maysir* through the outline of the concept of right, *haqq*, in Muslim law alternative to its religious/moral understanding. The Author maintains that these prohibitions are grounded more on efficiency of contract and equilibrium of the performances than on religion/ethic), and R.J. NEUWIRTH, *The Governance of Religion and Law: Insights from the Prohibition of Usury*, in *International Review of Law*, available at <http://www.ssrn.com/abstract=2487048> (last visited 21 February 2018).

⁶⁶ N.C. JENSEN, *Avoiding Another Subprime Mortgage Bust through Greater Risk and Profit Sharing and Social Equity in Home Financing: an Analysis of Islamic Finance and Its Potential as a Successful Alternative to Traditional Mortgages in the United States*, in *Arizona Journal of International and Comparative Law*, n. 25/2008, p. 825 ff.; H. AHMED, *Not Interested in Interest? The Case for Equity-Based Financing in U.S. Banking Law*, in *Entrepreneurial Business Law Journal*, n. 2/2007, pp. 479-485. See also P.S. MILLS, J.R. PRESLEY, *Islamic finance: theory and practice*, St Martins Press, New York, 1999, pp. 7-9; D. KLEIN, *The Islamic and Jewish Laws of Usury: A Bridge to Commercial Growth and Peace in the Middle East*, in *Denver Journal of International Law and Policy*, n. 23/1995, pp. 535-537: “[i]n one [hadith], it is reported that the Prophet ‘equated the taking and giving of interest to committing adultery thirty-six times, or being guilty of incest with one’s own mother”; C. WU, *Islamic Banking: Signs of Sustainable Growth*, in *Minnesota Journal of International Law* n. 12/2007, pp. 233-236; H.M. SHARAWY, *Understanding the Islamic Prohibition of Interest: a Guide to Aid Economic Cooperation between the Islamic and Western Worlds*, in *Georgia Journal of International and Comparative Law*, n. 29/2000, pp. 153-173.

⁶⁷ B.L. SENIAWSKI, *Riba Today: Social Equity, the Economy, and Doing Business under Islamic Law*, in *Columbia Journal of Transnational*, n. 39/2001, pp. 701-702.

See generally J.F. SEZNEC, *Ethics, Islamic Banking and the Global Financial Market*, in *The Fletcher Forum of World Affairs*, n. 23/1999, p. 161; G. BILAL, *Islamic Finance: Alternatives to the Western Model*, in *The Fletcher Forum of World Affairs*, n. 23/1999, p. 146; I. PERVEZ, *Islamic Banking and Finance*, in *Information Sources on Islamic Banking and Economics*, edited by S. Nazim Ali, Naseem N. Ali, Routledge, London, 1994, pp. 8-9.



to the lender along with the principal amount as a condition for the loan or for an extension in its maturity”⁶⁸.

For this reason, scholars disagree about the possibility to accept any increase as valid⁶⁹. Recently, a scholar stated that considering *riba* the same as interest is misleading, because “some forms of interest [...] should not be considered forbidden *riba*”⁷⁰.

Chibli Mallat warns that interpreting *riba* as a synonymous with interest would have tainted the whole civil and commercial structure of the society with illegality⁷¹.

The Qur'anic prohibition of *riba* reads:

“Those who devour *riba*
Will not stand except
As stands one whom
The Evil One by his touch
Hath driven to madness
That is because they say:
«[Sale] is like *riba*».
But Allah hath permitted [sale]
And forbidden [*riba*].
Allah will deprive
[*Riba*] of all blessing,
But will give increase
For [voluntary] deeds of charity;
For He loveth not
Creatures ungrateful
And wicked.
The Qur'an goes on to warn:
That they took [*riba*],
Though they were forbidden;
And that they devoured

⁶⁸ F. AL-OMAR, M. ABDEL-HAQ, *Islamic Banking: Theory, Practice and Challenges*, Zed Books, London, 1996, p. 8. See also *Fatwa of Kuwait Finance House, al Fatawa al Shar'iyah*, in *A Compendium of Legal Opinions on the Operation of Islamic Banking*, edited by Y.T. De Lorenzo, Institute of Islamic Banking and Insurance, London, 2004, p. 125.

⁶⁹ For a discussion of the major differences among the Islamic schools of law, see generally M.H. KHAN, *The Schools of Islamic Jurisprudence: a Comparative Study*, Kitab Bhavan, New Delhi, 1991.

⁷⁰ Z. IQBAL, A. MIRAKHOR, *An Introduction to Islamic Finance: Theory and Practice*, John Wiley and Sons, Singapore, 2011, pp. 55-56.

⁷¹ C. MALLAT, *The Debate on Riba and Interest in Twentieth Century Jurisprudence*, in *Islamic Law and Finance*, edited by C. Mallat, Graham and Trotman, London, 1988, pp. 69-88.



Men's substance wrongfully -
We have prepared for those
Among them who reject Faith
A grievous punishment"⁷².

The *riba* prohibition does not prevent the possibility that money could be lent under Islamic law, it merely forbids unearned profit (or, in other words, profit without expected and common business risks)⁷³.

According to Islamic jurists, the described prohibition aims at avoiding

"the illegality of all forms of gain or profit which were unearned in the sense that they resulted from speculative or risky transactions and could not be precisely calculated in advance by the contract parties"⁷⁴.

In addition to the verses above, the Qur'an further warns:

"O ye who believe!
Fear Allah, and give up
What remains of your demand
For [riba], if ye are

⁷² C. MALLAT, *The Debate*, cit.

⁷³ B.L. SENIAWSKI, *Riba Today*, cit., pp. 15-16, recognizing that both the Pakistani Federal *Shari'ah* Court (*Ur-Rahman Faisal v Secretary, Ministry of Law, Justice and Parl. Affairs, Gov't of Pak.* PLD 44 [1992]) and the Egyptian Supreme Constitutional Court, in *Rector of the Azhar University v President of the Republic*, Supreme Constitutional Court, *Shari'ah and Riba: Decisions in Case No. 20 of Judicial Year No. 1*, in *Arab Law Quarterly*, n. 1/1985, p. 100 ff., while interpreting national laws based on *shari'ah*, determined that interest falls under the definition of *riba* and it is therefore prohibited; C. MALLAT, *Commercial Law in the Middle East: Between Classical Transactions and Modern Business*, in *American Journal of Comparative Law*, n. 48/2000, pp. 125-128 (discussing the *Ur-Rahman Faisal* case and the rationale of the Pakistani Federal *Shari'ah* Court, including the fact that before ruling, the court analyzed the answers to 16 questions posed to "distinguished 'ulama, scholars, economists and bankers" concerning *riba* and banking practices). *Mahmood-ur-Rahman Faisal v Secretary* specifically addresses the question of whether all interest is *riba*. In his opinion, the Pakistani Federal *Shari'ah* Court draws upon the views of international Islamic bodies and institutions, Islamic legal scholars, economists, and lawyers. Its decision that interest in any amount is *riba* and it is therefore prohibited, along with its corresponding finding that *ra's al-mal* (the capital sum) is measured according to the number of units (not its value), represents the current Islamic legal community's point of view on the subject, although such view is not unanimously held. Consequently, twenty provisions of Pakistani law, each one related to simple interest in various situations, were struck down as unconstitutional because they directly violated the *shari'ah* prohibition on *riba* (as interpreted by the court to include simple interest).

⁷⁴ N.J. COULSON, *Commercial Law in the Gulf States: the Islamic Legal Tradition*, Graham and Trotman, London, 1984, p. 11.



Indeed believers.⁷⁵
If ye do it not,
Take notice of war
From Allah and His Messenger:
But if ye turn back,
Ye shall have
Your capital sums,
Deal not unjustly,
And ye shall not
Be dealt with unjustly”⁷⁶.

As anticipated, although the Qur'an clearly prohibits *riba*, what constitutes this forbidden practice is still a matter of debate⁷⁷.

The noun *riba* is associated to a pre-Islamic commercial habit made illegal by the Qur'an⁷⁸. The Arab society, at the time of the revelation of the Qur'an (7th century C.E.), was pre-capitalist: “production was limited, money was scarce [...] and barter trade prevailed”⁷⁹. This natural economy characterized all rural and tribal societies of the time⁸⁰.

The majority of persons, generally living at a subsistence level under pressing needs, took out loans from moneylenders and merchants (because at that time there was no systematic organization of credit lenders) to face critic situations such as a severe crop failure, a general famine or a hostile raid⁸¹.

Then the borrower could not repay the loan by the agreed date, the sum of money that had to be returned to the lender was often doubled (or increased by large increments) in exchange for a delay in payment.

As a result, the rate applied became exorbitant⁸². In response, the Qur'an states:

“O ye who believe!
Devour not *riba*,

⁷⁵ A. BAUSANI, *Il Corano*, Rizzoli, Milano, 1988, II, v. 278.

⁷⁶ A. BAUSANI, *Il Corano*, cit., II, v. 279.

⁷⁷ A.A. IBRAHIM, *The Rise of Customary Businesses in International Financial Markets: an Introduction to Islamic Finance and the Challenges of International Integration*, in *American University International Law Review*, n. 23/2008, p. 611 ff.

⁷⁸ A. BAUSANI, *Il Corano*, cit., II, v. 275.

⁷⁹ Z. HAQUE, *Riba: the Moral Economy of Usury, Interest and Profit*, Ikraq, Selangor, 1995, p. 3.

⁸⁰ Z. HAQUE, *Riba: the Moral*, cit., p. 31.

⁸¹ Z. HAQUE, *Riba: the Moral*, cit., pp. 26-33.

⁸² Z. HAQUE, *Riba: the Moral*, cit., p. 29.



Doubled and multiplied;
But fear Allah; that
Ye may (really) prosper”⁸³.

See also the following verses describing *riba*'s practice as disfavored and forbidden, respectively:

“That which ye lay out
For increase [(riba)] through the property
Of (other) people, will have
No increase with Allah:
But that which ye lay out
For charity, seeking
The Countenance of Allah,
(Will increase): it is
These who will get
A recompense multiplied”⁸⁴.

The «doubled and multiplied» refers to the “repetition of the process of doubling from year to year”⁸⁵. The pre-Islamic practice of allowing repayment deferral for an increase in the sum owed is the only one clearly indicated in records as *riba*. Thus, Ibn Hanbal, the founder of the Hanbali School of Islamic Law, declared that the practice of *pay or increase* is the only form of *riba* targeted with certainty by the Qur'an's prohibition⁸⁶. All the other forms of increase in financial transactions are surrounded by disagreement within the Islamic legal community⁸⁷.

What is certain is that in Islamic law the word *riba* means an inequitable increase. It refers to a situation in which unjust enrichment derives from an unequal (unfair) exchange, namely, an increase over the

⁸³ A. BAUSANI, *Il Corano*, cit., III, v. 130.

⁸⁴ A. BAUSANI, *Il Corano*, cit., XXX, v. 39. See K. REINHART, *Introduction to Laleh Bakhtiar, Encyclopedia of Islamic Law: A Compendium of the Major Schools*, Kazi Publications, Chicago, 1996, pp. 21-23; see also G.M. BADR, *Islamic Law: a Survey of Islamic International Law*, in *Proceedings of the Annual Meeting of the American Society of International Law*, n. 76/1982, p. 60 ff.; F.E. VOGEL, S.L. HAYES, *Islamic Law and Finance: Religion, Risk, and Return*, Kluwer Law International, The Hague, 1998, p. 23.

⁸⁵ Z. HAQUE, *Riba: the Moral*, cit., p. 35.

⁸⁶ F.E. VOGEL, S.L. HAYES, *Islamic Law*, cit., p. 73.

⁸⁷ S.H. HOMOUUD, *Islamic Banking: the Adaptation of Banking Practice to Conform with Islamic Law*, Arabian Information, London, 1985, p. 100.



principal amount lent or the quantity traded⁸⁸. Chapter II verse 275 states that “Allah has allowed sale and forbidden *riba*”. Recompense

“is the basic trait or the *conditio sine qua non* of a halal or lawful sale, because sale is necessarily an exchange of value against an equivalent value; an equitable return and compensation for the goods and services”⁸⁹.

Chapter II verse 276 contrasts *riba* with voluntary deeds of charity (as opposed to the mandatory alms-giving that is one of the *five pillars* of Islam)⁹⁰. Haque describes *riba* as an:

“inequitable social and economic system which destroys unity and solidarity of a community by creating classes of moneylenders, usurers, hoarders and merchants who own the basic means or production like land and capital, and exploit the common masses who lack these resources and virtually depend on them for their livelihood and existence”⁹¹.

Thus, according to the Qur'an, *riba* is an inequitable exchange, destructive, and out of place in a fair economic order⁹².

The concept of *riba* is not confined to money-lending but it extends to the exchange of goods as well. *Shari'ah* recognizes two forms of *riba*: *riba al-Nasiah* and *riba al-Fadl*⁹³. The distinction between *riba al-fadl* (excess on

⁸⁸ A.A. IBRAHIM, *The Rise*, cit., pp. 699-700, explains that prepaid forward sales were permissible because of the overriding benefit to agriculture and other industries, despite the excessive uncertainty about the subject matter. Buy-back or same-item sale-repurchase were also allowed because the benefits were greater than the risk that such transactions might have been a vehicle to charge interest.

⁸⁹ Z. HAQUE, *Riba: the Moral*, cit., pp. 7-11; A.B. DURREZ, *Riba in Islamic Law*, in *Islamic and Comparative Law Quarterly*, n. 6/1986, p. 57. See also V. CATTELAN, *In the Name of God: Managing Risk in Islamic Finance*, in *EABH Working Papers Series*, 2014, available at <http://www.ssrn.com> (last visited 21 February 2018).

⁹⁰ A. BAUSANI, *Il Corano*, cit., II, v. 276. (“Allah will deprive [*riba*] of all blessing, but will give increase for deeds of charity [*sadaqat*]”).

⁹¹ Z. HAQUE, *Riba: the Moral*, cit., pp. 8-9.

⁹² A.R.I. DOI, *Shari'ah: The Islamic Law*, Ta Ha Publishers, London, 1984, p. 381; A. ABDEL-FATTAH EL-ASHKER, *The Islamic Business Enterprise*, Croom Helm, London, 1987, p. 2; S.H. AMIN, *Banking and Finance Based on Islamic Principles - Law and Practice in Modern Iran*, in *Islamic and comparative law quarterly*, n. 9/1989, p. 4.

⁹³ Gold for gold, like for like, hand to hand and any excess is *riba*. Silver for silver, like for like, hand to hand and any excess is *riba*; grain for grain, like for like, hand to hand and any excess is *riba*; salt for salt, like for like, hand to hand and any excess is *riba*; barley for barley, like for like, hand to hand, and any excess is *riba*, dates for dates, like for like, hand to hand, and any excess is *riba*. And if the kinds differ, then sell as you wish, so long as it



exchange) and *riba al-nasi'a* (excess on loans) stems from the historical practice⁹⁴.

1) *Riba al-Nasiah* deals with *riba* in money-to-money exchange.

The term *Nasi'ah* - meaning to postpone, defer, or wait - refers to the extra time granted to the borrower for the repayment of the loan, in exchange for an addition or premium charged by the lender. The ban of *riba al-Nasi'ah* implies that the practice of fixing in advance a positive return on a loan as a premium for the above-mentioned extra time is not allowed by the *sharia*. It does not matter if the reward is due in a fixed or variable percentage of the principal, or as a predetermined amount⁹⁵.

is hand to hand. See **H.A. HAMOUDI**, *The Muezzin's Call and the Dow Jones Bell: on the Necessity of Realism in the Study of Islamic Law*, in *American Journal of Comparative Law*, n. 56/2008, p. 423, and **N.A. SALEH**, *Unlawful Gain and Legitimate Profit in Islamic Law*, Cambridge University Press, New York, 1986, pp. 19-20.

⁹⁴ During pre-Islamic times, trade was in commodities so, no unanimity among the Islamic legal community exists regarding currency exchanges where the currency has no intrinsic value because such modern practices are not specifically addressed in the sources of Islamic law. **M.H. BALALA**, *Islamic Finance and Law. Theory and Practice in a Globalized World*, Palgrave Macmillan, New York, 2011, p. 62. In deducing rules on *riba*, the classical jurists derived five rationales as the underlying causes to understand the principles governing *riba*. Collectively, such causes represent "mathematical equivalency; avoiding commercial exploitation; minimizing commerce in currency and foodstuffs; linking lawfulness of gain to risk-taking; [and] using money and markets to allocate and moderate risks". Another view about the prohibition of *riba* relates to distributive justice: money should keep circulating within society and not remain limited to a few hands. A more recent view is that the religious prohibition saves individuals from abusing the availability of potentially self-detrimental credit, helps avoid excessive indebtedness on account of individual's irrational behavior, and protects against "paying or receiving unfair compensation for receipt or extension of credit". The more popular view, however, is that interest is exploitative, and therefore prohibited. **A.A. IBRAHIM**, *The Rise*, cit., p. 700. Professor Sanhuri identifies three different purposes for the prohibition of *riba*: to prevent hoarding, to guard against turning currency into a commodity over which to speculate, and to ban fraud and exploitation over the trade in items of the same genus. **H. A. HAMOUDI**, *The Muezzin's*, cit., p. 450. Al-Sanhuri advocated something along these lines, thereby rendering the interest prohibition a nullity in the contemporary era. Using antiformalist tools such as *istislah* and *istihsan*, functionalists might take an additional step and expand earlier *hadith* to propose a doctrine on *riba* that would meet the functional objectives articulated in the Qur'an - namely, avoidance of exploitation or oppression resulting in unnatural gains to the stronger party (**H.A. HAMOUDI**, *Jurisprudential schizophrenia: on form and function in Islamic finance*, in *Chicago Journal of International Law*, n. 7/2007, p. 611).

⁹⁵ **N. HAMMAD**, *Compensation for an Obligation to Sell Currency in the Future (Hedging)*, in *Chicago Journal of International Law*, n. 7/2007, p. 521.



This kind of *riba* is the basis of the prohibition on interest in today's financial transactions⁹⁶. In simple terms, one should not be able to earn *money on money*. Money is seen as a medium of exchange without its own value except for the capability to give value to goods. The 'good' money earns value only when it is commodified⁹⁷;

2) *Riba al-Fadl* deals with barter or exchange. Its proscription is due to the sayings of the Prophet who required that commodities were exchanged for cash instead of by barter to prevent unfair behaviours.

In fact, the diversity in quality of the items bartered can lead to mismatches in the quantity and quality of the exchanges, which may give rise to an unjust enrichment, i.e. *riba*⁹⁸.

Riba is a vitiating factor that aims at attaining transactional equity by requiring exchanges to be bargains by way of mutual consent⁹⁹. It covers the abuses occurring in barter systems of the time. The rationale for the prohibition is based on an idea of fair dealing in exchange.

The aim is to promote equal bargaining in the transactions involving poor people with wealthy ones and, more generally, to allow any parties to have the ability to void a contract made under unfair terms in the case of a prohibited 'increase'¹⁰⁰.

⁹⁶ C. WU, *Islamic Banking*, cit., pp. 249-250, clearly states in other words that Islam prevents the reward for the time-value element. The reason for that is taken from an illustration of the Prophet using an unborn animal: "The price of a pregnant sheep should be increased in consideration of what it carries, even though the unborn animal itself could not be sold separately. Thus, time may be considered in setting a price, but it is not separable from the sold article, and the compensation for time is therefore included as part of the price of the article being sold". The reward for the time element is like rewarding the lender twice for the same product. The same Author added that, in Islam, risk-taking and sacrificed liquidity should be compensated.

⁹⁷ S.A. BHATTI, *The Shari'ah and the Challenge and the Opportunity of Embracing Finance "Without Interest"*, in *Columbia Business Law Review*, n. 205/2010, pp. 214-215.

⁹⁸ A. BAUSANI, *Il Corano*, cit., XXX, v. 39.

⁹⁹ M.H. BALALA, *Islamic Finance*, cit., p. 62.

¹⁰⁰ Seniawsky explains that if an "equal exchange" has in se the idea of the purchasing the power of money so that the "lender does not consistently lose value through loans to borrowers", then, an interest may be included up to the threshold limit, which is equal to inflation, without it being prohibited *Riba*. "The requirement that the lender receive its capital sums is satisfied by allowing for adjustments, upward or downward, in the contract price to reflect the real value of what was lent and what was repaid. Thus, amounts charged above the real (not nominal) value of the capital should be adjudged *riba*". As so defined, "the prohibition places the borrower and lender on equal footing: it treats all parties fairly,



Therefore, the rules of the *riba* of excess and *riba* of delay can be considered as a type of self-executing price-setting regulation¹⁰¹.

Riba, initially only discouraged, was gradually prohibited¹⁰².

As charging compound interest was prevalent in pre-Islamic Arabia, this was the first practice to be forbidden¹⁰³.

The rationale of the discipline of *riba* lies also in a moral perspective of the bargain: only the lender's benefit is certain (the lender's return is usually secured via collateral) while the borrower's efforts can potentially be without return: this situation is seen as being fundamentally unfair to borrowers¹⁰⁴. The prohibition on interest is seen as a tool to put the parties on a level playing-field¹⁰⁵.

When money is converted into a commodity or a capital asset, these can be rented out, leased, or sold for a margin of profit; in doing so, «the

and promotes harmony and goodwill between lender and borrower, or seller and buyer” (B.L. SENIAWSKI, *Riba Today*, cit., pp. 714-715 and pp. 718-719).

¹⁰¹ M.H. FADEL, *Riba, Efficiency, and Prudential Regulation: Preliminary Thoughts*, in *Wisconsin International Law Journal*, n. 25/2008, p. 694.

¹⁰² “Balancing economic freedom with risk of abuse” is the guiding principle during the classical age of Islamic law. See M.A. EL-GAMAL, *Islamic Finance: Law, Economics, and Practice*, Cambridge University Press, New York, 2006, p. 48. The Author refers also to a “benefit analysis” to interpret classical Islamic jurisprudence.

¹⁰³ I. WARDE, *Islamic Finance*, cit., pp. 1-2. Y.T. DE LORENZO, *The Religious Foundations of Islamic Finance*, in *Islamic Finance: Innovation and Growth*, edited by S. Archer, R.A. Abdel Karim, Euromoney Books and AAOIFI, London, 2002, pp. 9-10. It was common practice to charge interest at a certain maturity date and then compound, or double and multiply that interest at future maturity dates. The final prohibition was more clear and categorical, which came from one of the last verses of the *Qur'an* and prohibited, in the view of some scholars, compound interest.

¹⁰⁴ B.M. McCALL, *Unprofitable Lending*, cit., p. 549. M. ANDERSON, *The Threat to Interest-Free Home Financing: the Problem of State Governments’ Prohibition of Islamic-Compliant Financing Agreements*, in *Hamline Law Review*, n. 37/2014, p. 315, affirms that “[s]cholars argue that part of the prohibition against *riba* is a moral justification to protect the poor from being exploited by the rich. Additionally, the prohibition of *riba* is based on fundamental beliefs of economics unique to Islamic culture, which teaches that money has no value in and of itself, and all profit must be connected to something other than money that actually has value. The idea that economic exchanges must be equal and profits fair is also related to this concept. Therefore, those who choose to follow their faith and avoid paying interest do so not as a convenient means to avoid being charged late payments, but because of a fundamental disagreement on the nature of money and equitable profiting”.

¹⁰⁵ S.A. BHATTI, *The Shari’ah*, cit., pp. 213-214.



lender is acquiring the rental value of an intrinsically valuable good and is not “earning money on money itself”»¹⁰⁶.

This hermeneutical reconstruction, clearly, shows the algebraic equation of equity prevalence over debt, and the intent of dealing in tangibles. These tenets are the ground of every loan arrangement that in operative terms is translated into a Profit Loss Sharing Scheme (PLS) between the borrower and the lender (the *equity preference*), where the lender purchases a specific asset that will be sold back for a profit (the *tangibility preference*): the lender makes profit using the asset rather than the money itself¹⁰⁷.

Therefore, economically speaking, *riba* represents a ‘premium’ the borrower pays to the lender along with the principal amount and it is a sort of legal condition for the loan¹⁰⁸.

The forbidden interest rate has four features:

1) it is positive and fixed *ex-ante*; 2) it is tied to the time period and the amount of the loan; 3) its payment is guaranteed regardless of the outcome or the purposes for which the principal was borrowed; and 4) the state apparatus sanctions and enforces its collection¹⁰⁹.

The rules related to *riba* are grounded on five rationales “mathematical equivalency; avoiding commercial exploitation; minimizing commerce in currency and foodstuffs; linking lawfulness of gain to risk-taking; [and] using money and markets to allocate and moderate risks”¹¹⁰.

¹⁰⁶ S.A. BHATTI, *The Shari’ah*, cit., p. 215. F. SORVILLO, *Pene canoniche, sanzioni islamiche e modelli economico-speculativi: i diritti religiosi a sostegno della finanza etica*, in *Stato, Chiese e pluralismo confessionale*, n. 8/2016, available at www.statoechiese.it (last visited 21 January 2019), p. 5 underlines that the Islamic banking and finance is more resilient to economic crisis due to its profit and loss sharing nature resembling a sort of partnership with the client. See, on the PLS schema, G.M. PICCINELLI, *Operazioni islamiche di provvista e di gestione del risparmio: il modello del cliente-socio*, in AA. VV., *La banca islamica e la disciplina bancaria europea*, Giuffrè, Milano, 2006, pp. 20-21.

¹⁰⁷ S.A. BHATTI, *The Shari’ah*, cit., pp. 215-216. The same Author explains that the *riba* principle lies also on a social justice concern. Since one of the five pillars of the Islamic faith is the annual payment of a certain percentage of one's disposable income as *zakaat* or *alms for the poor* (and orthodox Muslims are required to give charitably at regular intervals to other classes of persons), prohibiting interest preempts its use as an exploitative and oppressive tool throughout the course of executing one's moral and social obligations (S.A. BHATTI, *The Shari’ah*, cit., pp. 216-217).

¹⁰⁸ See A.A. IBRAHIM, *The Rise*, cit., p. 699.

¹⁰⁹ A.A. IBRAHIM, *The Rise*, cit., p. 699.

¹¹⁰ F.E. VOGEL, S. L. HAYES, *Islamic Law*, cit., p. 78.



Others recognize in the distributive justice the fundament of the prohibition of *riba*: wealth should not stay in a restricted circle of people, but it should be spread among the members of the society¹¹¹.

A more recent view is that the religious prohibition saves individuals from abusing the availability of potentially self-detrimental credit, helps to avoid excessive indebtedness on account of individuals' irrational behaviour, and protects against "paying or receiving unfair compensation for receipt or extension of credit"¹¹².

10 - Similarities between the *sharia* prescriptions and the ancient Jewish ones

As already mentioned, the Jewish and Islamic laws of usury show numerous similarities¹¹³.

The majority of the authorities in both faiths prohibit the charging of interest at least between co-religionists.

As regards the Jewish law, the opportunity to lend money at interest has always existed but what originally was an exception, now it is the rule: all this happened through a traditional contractual mechanism called *heter iska*¹¹⁴.

¹¹¹ I.A. NYAZEE, *The Rules and Definition of Riba*, n. 7, available at <http://www.nyazee.org/> (last visited 21 February 2018).

¹¹² M.A. EL-GAMAL, *Islamic Finance*, cit., pp. 54-55 (arguing from the modern psychological and behavioural economic research "that humans exhibit fundamental forms of irrationality in time preference, against which precommitment mechanisms (including those based on religion) can protect them". See also A.A. IBRAHIM, *The Rise*, cit., p. 701.

¹¹³ It also serves as a reminder that Jews and Muslims share the same concern over the following principles: *i*) the protection of disadvantaged elements of their respective societies; *ii*) the moral component of business transactions; *iii*) the labour theories of value; and *iv*) adherence to religious authorities interpreting the word of the same God. A. ABDEL-FATTAH EL-ASHKER, *The Islamic Business*, cit. See also A.R. HARDIEE, M. RABOBY, *Risk, Piety, and the Islamic Investor*, in *British Journal of Middle Eastern Studies*, n. 18/1991, pp. 52-66.

¹¹⁴ D. KLEIN, *The Islamic*, cit., p. 535. See, e.g., M. LEWIS, *Comparing Islamic and Christian Attitudes to Usury*, in *Handbook of Islamic Banking*, edited by M.K. Hassan, M. Lewis, Edward Elgar, Cheltenham, 2007). See also, A. WEINGORT, *Intérêt et crédit dans le droit talmudique*, Librairie générale de droit et de jurisprudence, Paris, 1979, p. 492, and H. GAMORAN, *Jewish Law in transition - How economic forces overcame the prohibition against lending on interest*, Hebrew Union College Press, Cincinnati, 2008, p. 196.



The first point of contact lies in the fact that also “[t]he whole body of Jewish law is believed by the orthodox to be divine law, and hence to have absolutely and permanently binding force”¹¹⁵.

The Halacha, the body of Jewish law that is central for a religious Jew as the *sharia* is for Islamic religious people, addresses business and financial issues in depth. The relevance of business in the Jewish life is so well clear that the Talmud¹¹⁶ states that the first question a Jew is asked when he goes to heaven is: “Did you do business faithfully?”.

This simple - even if not easy - question should be understood as a benchmark to define, at least for religious Jews, their relationship with God. By all means, the law of usury occupies a central position in halachic business law. The biblical prohibition covers contracts with three essential elements: a) an agreement; b) at the time of the commencement of the loan; c) to pay or provide services to the lender in excess of the amount loaned. Such contracts constitute *ribbit ketzutzah* and are strictly prohibited; the contract is void *ab initio* and the borrower and the lender, as well as the scribe to the contract and any witnesses to the transaction, commit a serious sin.

As in both the Islamic and the Christian cultures, Jewish borrowers and lenders have found various ways to circumvent the prohibition on *ribbit*, including revocable sales (virtually identical to the original common law mortgage) and transactions through non-Jewish intermediaries. In the Middle Ages, these approaches mostly gave way to the *heter iska*¹¹⁷.

¹¹⁵ **H.H. COHN**, *Secularization of Divine Law*, in *Jewish Law in Ancient and Modern Israel: Selected Essays*, edited by H.H. Cohn, Ktav Publishing House, Jerusalem, 1971.

¹¹⁶ A brief explanation of the textual sources of Jewish law is in order. The Jewish law in its entirety is referred to as Halacha, a term roughly parallel to the Islamic Sharia. The Halacha is primarily composed of: 1) the Torah or Pentateuch, the first five books of the Old Testament, which is the written word of God as revealed through Moses on the Mount Sinai. The entire body of Halacha derives from the Torah; 2) the Mishnah, the oral code of law, which was written in the third Christian century. Because the Torah “is stated only in general terms [it] required explanation and amplification to be applied to daily living” (**E. ZIPPERSTEIN**, *Business Ethics in Jewish Law*, Ktav Publishing House, New York, 1983, p. 3 and p. 18). Commentaries on the Mishnah are known as the Gemara. There are two Gemara, the Babylonian and the Palestinian. The word *Talmud* consists of both the Mishnah and the Gemara; and 4) commentaries on the Talmud. The most important commentaries are those of Rashi, Maimonides, and Jacob ben Asher (**E. ZIPPERSTEIN**, *Business Ethics*, cit., pp. 17-19).

¹¹⁷ **M.H. LUBETSKY**, *Losing Interest: Financial Alchemy in Islamic, Talmudic and Western Law*, in *Transnational Law and Contemporary Problems*, n. 19/2010, p. 238.



Four scriptural verses ground the usury law¹¹⁸.

In short, it is forbidden to fix rates of return in partnership arrangements and, as a general rule, interest-bearing transactions are prohibited among Jews¹¹⁹. These restrictions do not apply to the dealings with Gentiles. The fact that any loan granted without interest to a Jew is considered a good *deed* (*mitzvot*) and an act of loving kindness (*chesed*) is strictly linked to the ratio on which is grounded the opportunity to lend at interest to Gentiles: namely, providing interest-free funds for Jews¹²⁰.

The Jewish usury law cannot be understood without a reference to the development and the general approval¹²¹ of *heter iska*, i.e. a kind of partnership agreement that, if carefully drafted, will look like a loan¹²² and, in so doing, will make it possible to circumvent the textual prohibition of interest in commercial transactions¹²³. The normal structure of *heter iska* is based on an agreement, in which we have a venturer supplying capital and a venturer providing labour (and, as often happens, some expertise in the field)¹²⁴. If the money is lost through theft or accident, this loss will be borne, at least in theory, by the lender¹²⁵.

However, while this is the default rule, *heter iskas* can, and almost always do, contain contractual provisions requiring the borrower to assume responsibility for the funds regardless of what happens to them. Only if the borrower is negligent, will he/she be responsible for the full amount. But,

¹¹⁸ See paragraph n. 1 of this text.

¹¹⁹ Most authorities forbid index in **G.M. TAMARI**, *With All Your Possessions: Jewish Ethics and Economic Life*, Collier Macmillan Publishers, London, 1987, p. 203.

¹²⁰ **M. TAMARI**, *With All Your*, cit., p. 170. Some scholars link the economic success of immigrant Jews to the availability of interest-free loans provided by their communities.

¹²¹ Not all authorities permit the *heter iska* (**E. BASRI**, *I, hereby, bequeath: A Comprehensive Guide to Jewish Wills*, Hakatav Institute, Jerusalem, 1975).

¹²² **D. KLEIN**, *The Islamic*, cit.

¹²³ Non-commercial loans require other mechanisms. For instance, the *heter mechira*, a type of lease/buy back arrangement, is the favoured method for structuring a loan for personal consumption. **E. BASRI**, *I, hereby, bequeath*, cit., p. 167.

¹²⁴ **E. ZIPPERSTEIN**, *Business Ethics*, cit., p. 44. This stipulation is required by a rabbinic ruling that partnerships, in which one party provides capital and the other labour, involve the labourer's payment. The person receiving the funds stipulates in the contract that he has previously been paid for his services. This agreement is evidenced in a document known as *shtar iska*.

¹²⁵ **A.S. COHEN**, *Halacha and the Contemporary Society*, Ktav Publishing House, New York, 1984, p. 217.



once the *heter iska* came into existence, “the prohibition on interest lost all practical significance in business transactions”¹²⁶.

11 - *Riba* and its recent openings¹²⁷

In Prophet Muhammad’s time, Mecca was Arabia’s wealthiest city and it depended on trade and pilgrimages of devout people. The continuous spread of Islam brought the region’s lucrative trade routes under Islamic control. As the economy became increasingly complex, many unknown questions started to be addressed.

When the colonial era came to an end, most areas of law were directly or indirectly inspired by Western models; newly independent States started to reassess their economic policies; with the decolonization and the new trend towards a return to Islam, religious scholars rethought economics and social sciences on the basis of their religious training. They did not simply assert ideas based on the divine revelations, but they analyzed them through logic, scientific theories and empirical evidence¹²⁸.

With the changes brought by oil-producing countries it was necessary to foster further thinking on economic matters. In 1976, the First Islamic Conference was held in Mecca; it was the first time in Islamic history that a high-level conference dealt exclusively with economic matters. Three years later, the King Abdul Aziz University established the International Center for Research in Islamic Economics (ICRIE) to support research in many subfields.

Islamic economics has always had to adapt to different circumstances. Sometimes, the Qur’an and the *sunna* do not manifest their

¹²⁶ E. ZIPPERSTEIN, *Business Ethics*, cit., p. 44.

¹²⁷ G. JEHL, *Innovation, Arbitrage, and Ethics: the Role of Lawyers in the Development of a New Transnational Islamic Finance Law*, in *Georgetown Law Journal*, n. 104/2016), pp. 1350-1351, states that “[t]he seriousness of the prohibition of *riba*, conventionally understood to encompass most forms of interest, is better understood as an excess paid or received on a principal that is in some manner a function of time, as reflected in several Qur’anic verses. This prohibition, perhaps more than any other, sets the Islamic finance industry apart from conventional interest-based finance and poses a serious challenge to structuring any financial transaction - from a simple consumer bank account to a sophisticated cross - border investment vehicle”.

¹²⁸ M. ARIFF, M. IQBAL, *The Foundations of Islamic Banking - Theory, Practice and Education*, Edward Elgar, Cheltenham, 2011, p. 45.



legal and conceptual content very clearly; therefore, establishing economic rules requires a strong effort (*ijtihad*).

As Islam expanded, it came into contact with different cultures and so it was necessary for Islamic jurisprudence to create legislation on problems which did not have any legal precedent that may be followed. Islamic jurisprudence provides a series of rules by means of which it is possible to interpret the *sharia*, though their existence does not preclude adaptive mechanisms¹²⁹.

It is possible to say that modern Islamic finance really started in the 1970s. It was largely driven by the oil boom and it was later transformed by the collapse of the oil prices in the 1980s and the changes in the global political and economic system¹³⁰.

As a consequence, to face this regulatory challenge, “[t]here are numerous bodies that oversee the Islamic financial system, interpret shari’ah law, and issue recommendations, fatwas, and other forms of guidance on how to invest in accordance with the will of Allah”¹³¹.

This multilevel and complex system has hindered or, at least, has slowed down the implementation of Islamic finance and its adaptation to the worldwide accepted practices.

The most important organization participating in this heuristic process of adaptation is the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).

¹²⁹ I. WARDE, *Islamic Finance*, cit., p. 38.

¹³⁰ Islamic Finance, in the modern sense, grew out of the broader Islamic Revival movement that began roughly in 1970s and signaled a reawakening of Muslim self-identity, evidenced by a growing adoption of Islamic culture, dress, terminology, and traditional Muslim values. Prior to this movement, when European colonial powers dominated almost the entire Islamic world, most countries adopted Western banking systems and commercial models and abandoned Islamic commercial practices. Accordingly, Islamic Finance is part of and is influenced by a more general desire to create a Muslim sphere of influence that is separate from the current dominant global economic and political order and “to restore some level of political and economic power to the Muslim world”. N.C. JENSEN, *Avoiding Another Subprime Mortgage Bust Through Greater Risk and Profit Sharing and Social Equity in Home Financing: an Analysis of Islamic Finance and its Potential as a Successful Alternative to Traditional Mortgages in the United States*, in *Arizona Journal of International and Comparative Law*, n. 25/2008, pp. 828-829. See also H.M. SHARAWY, *Understanding the Islamic*, cit., pp. 164-165 (explaining Islamic Finance as part of a broader Muslim “identity crisis”).

¹³¹ H.E. ROBBINS, *Soul Searching and Profit Seeking: Reconciling the Competing Goals of Islamic Finance*, in *Texas Law Review*, n. 88/2010, p. 1125.



This relatively young institution was founded in 1991 and it is peculiar because it does not develop products, but it simply gives the model framework in which the very financial product can be developed¹³².

However, the following institutions as well are noteworthy: The Islamic Financial Services Board (IFSB) in Malaysia; the Islamic International Rating Agency (IIRA)¹³³; the International Islamic Financial Market (IIFM), located in Bahrain; the International Islamic Fiqh Academy, which is located in Saudi Arabia and is an organ of the Organisation of the Islamic Conference¹³⁴.

These regulatory bodies are based in different countries, have different membership requirements and also methods for evaluating financial products; this puts some obstacles to the communication of a coherent message. The aforementioned situation is buttressed by the fact that these organizations are of relatively recent formation (having been established over the last fifteen years) and they are, therefore, subject to a process of constant evolution.

The issue regarding the legitimacy of bank interests started to be debated, within the Islamic world, since the beginning of the last century with the utmost urgency. In the absence of a developed Islamic economic theory tradition and as a consequence of colonisation, European models were adopted. Muhammad' Abduh, Egypt *mufti* from 1899 to 1905 (time of the protectorate), in a famous *fatwa* - published in 1905 - stated that interests paid on deposits by financial institutions were lawful.

Distinguishing the typical usurious increase - characteristic of the pre-Islamic era - from the share of profits deriving from a legitimate business, Abduh considered the interest rate granted by a bank as *shari'a*-compliant if derived from the profit earned by the bank itself.

Every person who deposits money knows that the bank will use it to conduct commercial operations from which the financial institution will,

¹³² "Furthermore, even institutions that heavily rely on the AAOIFI will normally also retain an internal or external shari'ah board that supervises compliance with these principles" (H.E. ROBBINS, *Soul Searching*, cit., p. 1125).

¹³³ The IIRA is the only agency furnishing traditional ratings (like Standard and Poor) and a *Sharia* Quality Rating (starting from 2005 and up to now it is the only agency providing this service. Its ratings measure the *sharia* compliance of certain Islamic financial institutions) of *sharia*-compliant institutions (Id).

¹³⁴ According to H.E. ROBBINS, *Soul Searching*, cit., p. 1135, in addition to the fragmented regulatory structure, the uncertainty is also given by the regional differences, the risk of changing rules and varying legal opinions and the fact there are only few qualified scholars.



eventually, gain some profit. This gain will be beneficial not only to the investors but even to the employees of the bank, to the State and, in general, to the entire society. Thus, trying to preserve their own capital, Muslims can legitimately earn a profit (interest) as part of a wider social and economic project. In recent years, starting from 1989, it has been affirmed - in a series of legal comments which have originated a strong debate - that interests paid on State's bonds are legal.

Through such activity the State can pursue objectives of exceptional social utility, which help the country's economic development and the citizens' cultural improvement. The source of justification of the interests linked to State bonds resides in the concept of public utility, which is also used by the classic jurists¹³⁵.

12 - *Riba* prohibition in the twentieth century and the *sharia*-compliant financial instruments¹³⁶

It has been stated that "[i]n the Islamic bank, the seventh century meets the 21st, as the partnering of investors and entrepreneurs continues to be an effective and economically viable technique"¹³⁷.

This quote highlights two fundamental facts.

¹³⁵ **M.A. EL-GAMAL**, *Incoherence of Contract-Based Islamic Financial Jurisprudence in the Age of Financial Engineering*, in *Wisconsin International Law Journal*, n. 25/2008, p. 605. See also **G.M. PICCINELLI**, *Continuità e discontinuità nell'Islam contemporaneo: linee per una lettura dei rapporti tra politica, diritto ed economia*, in *Le Relazioni transmediterranee nel tempo presente*, edited by G.M. Melchionni, Rubbettino, Soveria Mannelli, 2005.

¹³⁶ See **N.D. RAY**, *Arab Islamic Banking and the Renewal of Islamic Law*, Graham and Trotman, London, 1995; **C. MALLAT**, *From Islamic to Middle Eastern Law A Restatement of the Field (Part I)*, in *American Journal of Comparative Law*, n. 51/2003, p. 699, and **C. MALLAT**, *Commercial Law*, cit. See also **M.S. KHAN**, *Islamic Interest-Free Banking: a Theoretical Analysis*, in *International Monetary Fund Staff Papers*, n. 33/1986, pp. 1-27; **T.S. ABDUS-SHAHID**, *Interest, Usury and the Islamic Development Bank: Alternative, Non-Interest Financing*, in *Law and Policy International Business*, n. 16/1984, p. 1100, and **N.A. SALEH**, *Unlawful Gain And Legitimate Profit In Islamic Law: riba, gharar and Islamic Banking*, Kluwer Law International, The Hague, 1992, p. 16.

¹³⁷ **M. BARAKAT**, **E. SARVER**, *Comment: Western Banks Taking 1st Steps into Islam's 'No Interest' World'*, in *American Banker: banking and financial news*, 30 January 1997, p. 9.



On the one hand, Islamic banking¹³⁸ institutions rely on tradition¹³⁹, while, on the other hand, they base their financial transactions on the viability of the partnership model¹⁴⁰.

Considering the eminent role of tradition in Islamic banking, commentators point out that the practitioners of Islamic finance must comply with some basic rules to implement original Islamic financial products: 1) avoid interest or unlawful gain¹⁴¹; 2) avoid excessive risk-

¹³⁸ See **F. CASTRO**, *Banca Islamica*, in *Digesto Delle Discipline Privatistiche*, Sezione civile, Utet, Turin, 1988, p. 83. See also, recently, **I. SOUMARÉ**, *La pratique de la finance islamique*, in *Assurance et Gestion des Risques/Insurance and Risk Management*, n. 77/2009, pp. 59-78; **A.E. SOUAIJA**, *Theories and Practices of Islamic Finance and Exchange Laws: Poverty of Interest*, in *International Journal of Business and Social Science*, 2014, available at <http://ssrn.com> (last visited 21 February 2018); **M.A. EBRAHIM**, *Risk Management in Islamic Financial Institutions* (available at <http://ssrn.com/abstract=2528463> - last visited 21 February 2018); **S.M. FARIDUL**, *Islamic Banking: a True Alternative to Interest-Based Conventional Banking*, in *International Scholar Journal of Accounting and Finance*, n. 1/2015, pp. 33-40, and **R. POWELL**, **A. DELONG**, *The Possible Advantages of Islamic Financial Jurisprudence: an Empirical Study of the Dow Jones Islamic Market Index*, in *Fordham Journal of Corporate and Financial Law*, n. 19/2014, pp. 393-423.

¹³⁹ See **G.M. PICCINELLI**, *Continuità e discontinuità*, cit.

¹⁴⁰ See also **U.F. MOGHUL**, *No Pain, No Gain: the State of the Industry in Light of an American Islamic Private Equity Transaction*, in *Chicago Journal of International Law*, n. 7/2007, pp. 484-486, the Author explains in detail the Partnership idea of the Islamic Finance. According to this Author, Islamic finance is the most recent attempt to bring the finances and economies of both individuals and nations into compliance with the Divine. Partners are required to meet a variety of additional conditions such as: a) their legal authority to the contract, their delegate authority, and the fact that they must serve as guarantors; b) the capital must be specified and present at the time of contract and made of fungible money; c) the ratios of profit-sharing must be known and precisely specified at the time of contract, as well as the percentage of each partner; in other words, profit entitlement has not to be specified as a particular amount neither has to be tied to a particular capital contribution, because the total amount of profits is unknown, and Islamic law forbids a guaranteed, fixed return; d) in the case of loss, partners must share losses on a *pro rata* basis. Like any private equity investor, this Islamic bank conducted its preliminary due diligence to determine whether this particular investment transaction was economically worthwhile (**G.M. PICCINELLI**, *The Provision and Management of Savings: the Client-partner Model*, in *Islamic Banking*, cit., edited by M.F. Khan, M. Porzio, pp. 23-39).

¹⁴¹ It is true that economic progress is often linked with risk. However, in Islamic finance, risk is not held by one party to the transaction (as in Western finance), but it is rather shared by all parties. And while this approach is not necessarily unique compared to other religions, these principles are combined with specific guidelines for trade and commerce. According to Islamic concepts of social justice, lenders and borrowers must share both rewards and losses, not simply a fixed, risk-free return. Wealth accumulation within an economy must be distributed in a fair manner reflecting actual gains in productivity and innovation (**B. KHAN**, **A. CROWNE-MOHAMMED**, *The Value of Islamic*



taking, *gharar*¹⁴²; 3) recognize that money is not a commodity; 4) prohibit specific industries¹⁴³; 5) recognize that money does not change in value as time passes¹⁴⁴.

The words reported above correspond to the official position of the Institute of Islamic Banking and Insurance, which has stated that: 1) in broad terms, Islam prohibits all forms of economic activity which are morally or socially outrageous; 2) While acknowledging the individual's right to own wealth legitimately acquired, Islam makes it obligatory to spend that wealth judiciously, without keeping it idle or squandering it; 3) While allowing an individual to retain any surplus wealth, Islam seeks to reduce the margin of the surplus for the well-being of the community as a whole; 4) Islam seeks to prevent that the accumulation of wealth in a few hands could lead to the detriment of society; 5) The Islamic economic system pursues social justice and a no-self-destructive individual enterprise¹⁴⁵.

However, not every partnership arrangement is consistent with the Islamic principles.

An important objective of the Islamic banking movement¹⁴⁶ is the implementation of a system which ensures that Islamic banking

Banking in the Current Financial Crisis, in *Banking and Finance Law Review*, n. 29/2010, p. 441). See also, from a sector-based perspective, **G.M. PICCINELLI**, *Banques Participatives Et Investissements Pour Le Développement Méditerranéen* (Actes Du Seminaire, Rome, 27 Mai 1995), Ipo, Rome, 1996.

¹⁴² It has been stated that, in the conventional system, banks have asymmetric information, since it is really hard for them to control the business they have financed; in particular, it is difficult to discover the way in which a debtor will use the funds. An Islamic bank, on the other hand, has a valuable insight into the operations of the company being part of it. Since, then, an Islamic bank is tied to the business it finances, it could be said that the wealth of the financial system is strictly connected to the overall economy (**B. KHAN**, **A. CROWNE-MOHAMMED**, *The Value*, cit.).

¹⁴³ **A.A. IBRAHIM**, *The Rise*, cit. In the case of wine and gambling, the Qur'anic solution was complete avoidance, since those activities are not essential. By contrast, transfers of credit and risk are at the heart of finance and without them an economic system cannot function. The Islamic legal solution, in this case, was to impose restrictions on the means of transferring credit and risk, through prohibitions of *riba* (i.e., usury) and *gharar* (i.e., excessive uncertainty and ambiguity). The forbidden *riba* is essentially 'trading in credit' and the forbidden *gharar* is 'trading in risk', such as unbundled commodities.

¹⁴⁴ **G. BILAL**, *Islamic Finance*, cit., p. 146. See also **A.A. MUSCATI**, *Late Payment in Islamic Finance*, in *UCLA Journal of Islamic and Near Eastern law*, n. 6/2006, p. 47.

¹⁴⁵ **Y.T. DE LORENZO** (edited by), *A Compendium*, cit.

¹⁴⁶ For an explanation of its first developments see **M. ANWAR**, *Islamicity of Banking and Modes of Islamic Banking*, in *Arab Law Quarterly*, n. 18/2003, p. 62.



institutions' actions comply with *sharia*. According to this model, a supervisory board of religious advisors reviews all proposed financial transactions¹⁴⁷.

These supervisory boards provide guidance to the bankers and help them to respect the *sharia* principles.

Typically, when confronted with an unprecedented issue, the banker poses a question to the *sharia* Board and then, a fatwa, *id est* a comment interpreting the Islamic law, is returned¹⁴⁸.

According to the opinion of Talal De Lorenzo, in the modern Islamic finance industry, the *Sharia* Supervisory Board (SSB) is the single most important factor in the management of risk¹⁴⁹.

As it is commonly known, in order to be accepted by Muslim consumers and investors, a financial product or service must be *sharia*-compliant, in other words, it must first have the approval of a religious authority¹⁵⁰.

This necessity is so deeply rooted that "without formal approval through certification by means of a fatwa, no issuer or product provider will be able to market the financial service or product successfully to the Islamic financial community"¹⁵¹.

¹⁴⁷ J.M. TAYLOR, *Islamic Banking - The Feasibility of Establishing an Islamic Bank in The United States*, in *American Business Law Journal*, n. 40/2003, p. 385.

¹⁴⁸ Efforts have been undertaken to compile and index these *fatwas* to help develop uniformity in the relatively young field of Islamic banking. See, e.g., Y.T. DE LORENZO (edited by), *A Compendium*, cit.

¹⁴⁹ Y.T. DE LORENZO, *Shari'ah Compliance Risk*, in *Chicago Journal of International Law*, n. 7/2007, p. 397.

¹⁵⁰ In some jurisdictions, regulators now require both a *Sharia* Supervisory Board and a fatwa for any company offering Islamic financial services and products (Y.T. DE LORENZO, *Shari'ah Compliance*, cit., p. 397). C. ARJONA, G. JEHLE, *Islamic Law and the Limits of Amoralism: Re-Conceptualizing the Legal Ethics of Transnational Islamic Finance*, in *Transnational Law & Contemporary Problems*, 27/2018, p. 249 reminds that "Muslim customers and investors demand services that fully comply with Shari'ah rules, primarily the prohibition of *riba*". Furthermore, "Islamic law is not static and, in fact, the classical jurists provide several permissible techniques for adapting the law to the changed circumstances, including the Hanafi concept of *hiyal* (legal stratagems, also referred to as *makharij*, or exits) and various methods of choosing among divergent scholarly opinions (*tatabu*" al-rukhas, *talfiq*), as well as forms of equitable reasoning such as *istihsan* and *istislah*".

¹⁵¹ Y.T. DE LORENZO, *Shari'ah Compliance*, cit., p. 397.



This certification, therefore, plays a crucial role for a Muslim client since it guarantees that a product complies with the legal regulations and with the *sharia* rules and standards¹⁵².

Therefore, even if there is a deep-rooted criticism regarding the modern Islamic financial transactions considered almost identical, at least in substance, to the conventional finance products, the opinions of a board of scholars (re)assure orthodox Muslims that they are not performing any condemned *riba* practice¹⁵³.

However, the mere fact that a fatwa has been issued or that a SSB is present is not enough to guarantee the market acceptance of a financial product or service¹⁵⁴.

This happens because there is the risk that a fatwa is (i) ambiguous and, so, it will not be correctly understood, (ii) is not sufficiently detailed, or (iii) is too detailed and thus indecipherable. At the same time, also SBBs

¹⁵² **Y.T. DE LORENZO**, *Shari'ah Compliance*, cit., pp. 399-400. Typically, SSBs assist in the pre-certification stages, such as product development and structuring, or in the early stages of operations. Then, the SSB will issue a *fatwa* to certify the finished product, process, or service. In the case of a *sharia*-compliant offering, this will take place before an Offering Memorandum or Prospectus is issued or before a product is introduced to the market. By this stage, the SSB should have worked with the management to identify and to mitigate all possible *sharia*-compliant risks. Thereafter, the SSB will continue to assist in the risk management of the product or service. Besides, **J.M. TAYLOR**, *Islamic Commercial Banking-Moving Into the Mainstream?*, in *The Transnational Lawyer*, n. 18/2005, p. 417, the Author clearly underlines that "shari'ah board members are performing due diligence on behalf of the consumers who are without access to the details of what is offered to them and without experience or qualifications to evaluate those details in light of shari'ah teachings. In other words, shari'ah supervisory boards directly represent the Muslim investor's and consumer's religious interests". **B.H. MALKAWI**, *Shari'ah Board in the Governance Structure of Islamic Financial Institutions*, in *American Journal of Comparative Law*, n. 61/2008, p. 539, and **R. WILSON**, *Shariah Governance for Islamic Financial Institutions*, in *Journal of Islamic Finance*, n. 1/2009, pp. 59-64.

¹⁵³ Furthermore, this perception is extremely powerful in a postcolonial context, **M.M. TOMEH**, *Persuasion and Authority in Islamic Law*, in *Berkeley Journal of Middle Eastern and Islamic Law*, n. 3/2010, pp. 141-171, poses a rhetoric question: "which way do we follow, our own tradition or that of others?". Interest has been decried as a Western institution and a tool of exploitation and imperialism. See, e.g., **M.A. EL-GAMAL**, *Contemporary Islamic Law and Finance: the Tradeoff Between Brand-Name Distinctiveness and Convergence*, in *Berkeley Journal of Middle Eastern and Islamic Law*, n. 1/2008, p. 194, who talks of repackaging the so called Islamic financial transaction in order to mimic conventional finance transactions simply adding "transaction costs without promoting the social justice concerns that ostensibly underlie the appeal of Islamic finance".

¹⁵⁴ **Y.T. DE LORENZO**, *Shari'ah Compliance*, cit., p. 401.



bear the risk of not being accepted as a qualified authority¹⁵⁵ to give an opinion on a particular financial service¹⁵⁶.

The Islamic financial institutions, by means of these *fatwa*, create and implement products and tools to carry out interest-free banking transactions according to the partnership model¹⁵⁷.

In developing these instruments, an Islamic financial institution considers the philosophy of risk sharing (in order to avoid the predetermined and fixed interest rate in favor of a profit and loss sharing arrangement between the creditor and the debtor)¹⁵⁸ and the promotion of the social and economic welfare (the promotion of an entrepreneurship that goes beyond profit maximization)¹⁵⁹.

¹⁵⁵ "Factors that influence the selection of scholars for an SSB generally include their: (1) public reputations as academics; (2) relevant honors and titles; (3) advisory roles with public institutions; (4) publications (especially on the subject of Islamic finance); (5) membership on the shari'ah boards of reputable international financial institutions; (6) their academic backgrounds and other fundamental qualifications like facility in both the English and Arabic languages, and appreciation for the broader social and economic contexts of Islamic Finance; and (7) availability. In recent years, as demand for such scholars has continued to grow, this particular consideration has taken on added significance. In businesses that require quick decisions-securities trading, private equity, and the like-the issue of accessibility can be crucial" (Y.T. DE LORENZO, *Shari'ah Compliance*, cit., pp. 401-402).

¹⁵⁶ Y.T. DE LORENZO, *Shari'ah Compliance*, cit. Financial institutions normally require an SSB with local or regional membership only. In any case, it is a good practice to hire scholars of international repute whose backgrounds cover a broader cultural and linguistic constituency. Then, it is necessary to bond the activity of the SBB and of the management in order to reduce the risk of compliance with the *sharia* principles.

¹⁵⁷ See A. BANAGA, G.H. RAY, C. TOMKINS, *External Audit and Corporate Governance in Islamic Banks: A Joint Practitioner - Academic Research Study*, Avebury, Aldershot, 1994, p. 13.

¹⁵⁸ See M.A. EL-GAMAL, "Interest" and the Paradox of Contemporary Islamic Law and Finance, in *Fordham International Law Journal*, n. 27/2003, pp. 108-111 (describing the dichotomy between those scholars who view interest as unlawful under Islamic law and those who have more relaxed views on Islamic banking and finance).

¹⁵⁹ M.J.T. McMILLEN, *Asset Securitization Sukuk and Islamic Capital Markets: Structural Issues in These Formative Years*, in *Wisconsin International Law Journal*, n. 25/2008, p. 703, dealing with *sharia* issues where unanimity among the *sharia* boards is missing. The Author lists some of these cases: 1) the breadth of the indemnity provided by the project sponsor in respect of operational matters; 2) the permissible segmentation of the overall transaction to facilitate *hissa* purchases by the banks; 3) the nature of relevant events (such as construction milestones) and whether *hissa* purchases may be effected at those times or whether *hissa* purchases may only be effected at the completion of construction; 4) profit and loss allocations among the members of the *musharaka*; 5) the times at which the *murabaha* agreement or agreements pertaining to the sale of the *hissas* by the banks to the



13 - Solutions

Although the description of the main Islamic financial instruments¹⁶⁰ is essential to fulfill the present survey, a premise is necessary.

project sponsor may occur; 6) the valuation of the *hissas* in connection with the *murabaha* sales; and 7) the matters previously discussed in connection with the AAOIFI Sukuk Clarification. **A. FUCCILLO, F. SORVILLO**, *Religious freedom and objectives for economic intercultural development*, in *Stato, Chiese e pluralismo confessionale*, n. 10/2013, available at www.statoechiese.it (last visited 21 January 2019), p. 7, states that “[r]eligions have in fact always confronted economic systems in their doctrine, relating them mainly to the ethics of their teachings, and in this field each of them has a flourishing tradition that has an impact on individuals and guides their actions. The consequences are evident in areas (such as economics), too often superficially described as completely secularized, where the sacred and sacredness are something extraneous or irrelevant, but in which the impact of certain religious ideologies becomes nevertheless tangible. Today, in fact, it are the effects of ethical references (traditionally -though not exclusively – the domain of religions) that revive the idea of an economic development equal for all, and a decisive rejection of the serious inequalities that characterize modern globalized societies”. The same author goes on saying that “[i]n this way, banking is not exclusively aimed at corporate profit maximization, but must work towards building a sustainable economy in which it become an instrument supporting the principles of social justice and equitable distribution of wealth among all of the members of the Islamic community. In this sense, religion becomes a function of moral suasion of individuals, but especially of the company managers, forced, in their selection of targets and parameters of corporate positioning, not only to take into account factors like profit and the stability or survival of their companies in the markets, but also to provide a coherent response to the values imposed by religious observance. This framework, combined with the strong sense of religious affiliation that characterizes Muslim society, it becomes fully functional in conveying the choices of “client-believers” to forms of banking products specifically designed to ensure satisfaction and respect for their needs, in particular those of a religious nature. However, these results are not the exclusive preserve of Islamic banks.” **A. FUCCILLO, F. SORVILLO**, *Religious freedom*, cit., p. 16.

¹⁶⁰ For a quick survey of the most famous Islamic financial instruments see **A.U. KAZI, A.K. HALABI**, *The Influence of Quran and Islamic Transactions*, in *Arab Law Quarterly*, n. 20/2006, p. 325. There, the description of these instruments is followed by a brief history of the Islamic banking system.

¹⁶⁰ **U.F. MOGHUL**, *Separating the Good from the Bad: Developments in Islamic Acquisition Financing*, in *American University International Law Review*, n. 23/2008, pp. 735-736, clearly underlines that, in recent time, the Islamic finance industry has seen the establishment and growth of an Islamic private equity and of an Islamic venture capital. Related to this matter, the same Author, at pp. 740-741, specifically deals with the fundamental issue of Escrow arrangements. This legal instrument is commonly used in equity transactions to secure a party in case of a representation or warranty breach or an indemnity claim. Normally, the bank, as escrow agent in exchange for a fee, follows indications (included in an escrow agreement with the list of permitted investments) related to investment of the escrow property. If, on the one hand, the structure of such agreement is not problematic (since it is similar to the Trust and where the trustee under Islamic law is generally not deemed



In the world of Islamic financial instruments, the only ones which reflect perfectly the profit and loss sharing principle (and, hence considered unanimously *Halal*) are *Mudàraba* and *Mushàraka*.

In other Islamic financial operations, the financier is paid for his services through fees¹⁶¹ or mark-ups on the price of the goods bought with his help, and the risk sharing is more nuanced.

liable for losses or damages to the property in trust absent his negligence, wilful misconduct, or breach of obligations to the property owner. See **F.E. VOGEL, S.L. HAYES**, *Islamic Law*, cit., pp. 114-116 and 112-113 (mentioning that Islamic fiduciary law generally favours the trustee because the owner selected the trustee). This principle is the inverse of the Anglo-American common law governing fiduciary conduct. See **ID.**, p. 113, on the other hand, the list of permitted investments commonly found in such agreements was problematic; this was identified at the outset by counsel prior to *sharia* department review. The prohibition of *riba* extends to the receipt of interest on investments of the type typically permitted in escrow agreements as well as the investment in companies having *riba*-based income. In 1998, the Dow Jones Islamic Market Indexes' *sharia* board issued a fatwa setting forth a series of tests to determine the basis on which a publicly traded company was acceptable. There, the description of these instruments is followed by a brief history of the Islamic banking system.

¹⁶¹ **U.F. MOGHUL**, *Separating the Good from the Bad: Developments in Islamic Acquisition Financing*, in *American University International Law Review*, n. 23/2008, pp. 735-736, clearly underlines that, in recent time, the Islamic finance industry has seen the establishment and growth of an Islamic private equity and of an Islamic venture capital. Related to this matter, the same Author, at pp. 740-741, specifically deals with the fundamental issue of Escrow arrangements. This legal instrument is commonly used in equity transactions to secure a party in case of a representation or warranty breach or an indemnity claim. Normally, the bank, as escrow agent in exchange for a fee, follows indications (included in an escrow agreement with the list of permitted investments) related to investment of the escrow property. If, on the one hand, the structure of such agreement is not problematic (since it is similar to the Trust and where the trustee under Islamic law is generally not deemed liable for losses or damages to the property in trust absent his negligence, wilful misconduct, or breach of obligations to the property owner. See **F.E. VOGEL, S.L. HAYES**, *Islamic Law*, cit., pp. 114-116 and 112-113 (mentioning that Islamic fiduciary law generally favours the trustee because the owner selected the trustee). This principle is the inverse of the Anglo-American common law governing fiduciary conduct. See **ID.**, p. 113, on the other hand, the list of permitted investments commonly found in such agreements was problematic; this was identified at the outset by counsel prior to *sharia* department review. The prohibition of *riba* extends to the receipt of interest on investments of the type typically permitted in escrow agreements as well as the investment in companies having *riba*-based income. (In 1998, the Dow Jones Islamic Market Indexes' *sharia* board issued a fatwa setting forth a series of tests to determine the basis on which a publicly traded company was acceptable as the target of an investment. Among other things, this fatwa applied the prohibition of *riba* with some discretion to arrive at a certain tolerance threshold of the presence of *riba* as well as other prohibitions). "As an entity operating per Islamic norms, the buyer could not agree to the permissibility of such typically permitted investments



And here finds its place the concept of *hila* (Arabic plural: *hiyal*), or legal fiction. Throughout these stratagems, a legal transaction is created that, even if substantially void, becomes formally acceptable¹⁶².

According to this legal technique, the main challenge faced by the *sharia* finance industry (but also by the operators and advisors of the market) is to ensure that the label '*sharia*-compliant' is only applied to products complying with the underlying ethical basis of *sharia* financing¹⁶³.

neither for itself, nor for its counterparty, the seller. The parties did, however, agree that the escrow property would belong to the seller, and, as can be expected, the seller sought to invest its property in the manner it deemed fit. The conclusion that the escrow property would belong to the seller certainly made structuring an alternative escrow agreement all the easier from an Islamic legal perspective. The buyer was primarily concerned that the types of permitted investments be suitable for the purposes of the escrow. The escrow property had to be kept intact to the maximum extent possible and be liquid and readily available in the event the buyer was to make a claim for it. Ultimately, the parties agreed on these conditions as the required investment parameters. It must be mentioned that such an unconventional escrow arrangement required a flexible bank as escrow agent with an appreciation of the long-term potential of the growing Islamic investments market". See also U.F. MOGHUL, *Separating the Good*, cit., p. 741.

¹⁶² These stratagems are both linguistic (the substitution of the word profit for interest, for instance, was considered sufficient to render a substantively conventional loan 'Islamic') and legal (the sequence of perfectly valid agreements that combined together reaches unlawful outcomes). O. AGHA, *Islamic Finance: Principle Before Profit*, in *Berkeley Journal of Middle Eastern and Islamic Law*, n. 2/2009, pp. 128-129. Scholars disapprove of this tactic as it is deceptive and may constitute a form of hypocrisy; it enables potential third parties to participate in a non-compliant transaction with the false belief that it is a genuine transaction.

¹⁶³ W.S. HEGAZY, *Contemporary Islamic Finance: From Socioeconomic Idealism to Pure Legalism*, in *Chicago Journal of International Law*, n. 7/2007, p. 581, says that the driving force in the current prevalence of the legalistic trend in Islamic finance is the use of legal stratagems (*hiyal*). Jurists distinguish between two main categories: 1) stratagems designed to achieve an outcome or objective sanctioned by the *sharia* and 2) stratagems designed to circumvent the substance of an Islamic rule or prohibition. In general, stratagems under category 1) are considered legitimate solutions (*makharij shar'iyya*) if they employ a lawful means to reach an outcome permissible under the *sharia*, even if such outcome is not the primary, or default, outcome intended by the *sharia* for the use of such a means. G.M. PICCINELLI, *Il sistema bancario islamico*, in *Oriente Moderno*, n. 1/1988, and, specifically, in the Introduction to this work, *I principi e gli istituti finanziari islamici: alcuni aspetti giuridici relativi alle banche islamiche*, pp. 1-44. From a descriptive point of view, "hiyal could be seen as excessive human intervention in the divine principles and laws set down by the Qur'an and Sunna". The author follows stating that Islamic industrious merchants in the Middle Ages developed legal fictions and formalisms not for their own sake (i.e., not for the mere purpose of having a formalism), but for the underlying objective was to avoid adverse kadi judgments, rulings that would deem their financial transactions contrary to the Shari'a. These legal fictions "arose outside of, and alongside" the body of Islamic law, a corpus that



a) *Musharaka* (Partnership Arrangement)

The *musharaka* (partnership) is an agreement in which the financial institution provides part of the capital required by its customer in consideration of the fact that profits and losses will be proportionally shared according to a pre-negotiated agreement. The financial institution provides a percentage of the capital needed by its customer, who in return will proportionately share profits and losses in accordance with a formula agreed upon before the transaction¹⁶⁴.

The customer contributes to the business by providing some capital and sweat equity, represented by his management efforts and know-how¹⁶⁵. Sometimes the activity of the customer is taken into account when deciding the shares: profits are divided proportionally not only to capital contribution but even to the labour supplied¹⁶⁶.

Islamic banks, especially in home financing, use a modified version of this contract called *musharaka mutanaqisah* (diminishing partnership)¹⁶⁷. Here, the Islamic bank and its beneficiary enter into a partnership related to the ownership of an asset, on the condition that the bank "will gradually sell [its] share to the beneficiary at an agreed price and in accordance with an agreed schedule"¹⁶⁸.

The Islamic bank provides the financing for early acquisition of the property. The pre-determined payment schedule, through which the Islamic bank sells its share in the asset to the beneficiary, is benchmarked to the prevalent market interest rate. Although charging interests directly on

was itself "in the process of development." In time, these legal fictions were subsumed into Islamic Law, becoming "essentially part of the body of the Shari'a." Not surprisingly, however, *hiyal* were not universally accepted by the classical Muslim jurists and their madhabs, or legal schools. E. GROSSMAN, *The Human Dimension of Shari'a Law*, in *New York University Journal of International Law and Politics*, 50/2018, p. 1030. To sum up the different approaches, the Hanafi school is the most supportive of *hiyal*, the Maliki school is has not a clear cut position, the Shafi'i school ranged from a denial of *hiyal* to a mild acceptance, and, finally, the Hanbali scholars are against *hiyal*. E. GROSSMAN, *The Human*, cit., pp. 1030-1031.

¹⁶⁴ See A. BANAGA, G.H. RAY, C. TOMKINS, *External Audit*, cit., pp. 14-15.

¹⁶⁵ See I. PERVEZ, *Islamic Banking*, cit., p. 21.

¹⁶⁶ See H. VISSER, *Islamic Finance - Principles and Practice*, Edward Elgar, Cheltenham, 2013, pp. 55-57. The Author explains that this practice is not always accepted because of the difficulty to measure the labour and translate it into shares.

¹⁶⁷ See I. PERVEZ, *Islamic Banking*, cit., p. 21.

¹⁶⁸ I. PERVEZ, *Islamic Banking*, cit., p. 21.



asset-financing would be subject to the *riba* prohibition, Islamic banks have largely adopted this transaction structure.

b) *Mudaraba* (or Venture Capital Transactions)

Mudaraba is a special kind of partnership in which one party gives money to another for investing it in a commercial enterprise¹⁶⁹. In practice, it can be translated as a trustee finance contract (or trust financing) or *fiducia* and it is also known with the name *qirad*. The bank, or any other money provider, acts as a financier (*rabb-ul-mal*) and provides the entire capital needed for financing a project. The other party, the agent (*mudarib*), manages the venture and brings their labour and expertise in.

The capital provider is similar to a sleeping partner.

Parties agree beforehand on the proportion in which they share any profits, while losses are borne exclusively by the capital provider. The agent cannot share any loss, because the *sharia* stipulates that one cannot lose that he did not contribute¹⁷⁰.

The main differences with *musharaka*, explained in the previous paragraph, are that the financier has no right to participate in the management (which is carried out only by the *mudarib*) and its liability is limited to its investment. In case the bank participates in the management of the affairs, this will be done for a fee¹⁷¹.

The agreement rules that the financial institution will take an agreed upon percentage of the profits but, as in the civilian case of the association in participation, it will bear the risk of losing the monetary funds invested¹⁷². Therefore, a possible loss is only suffered by the *rabb-ul-mal*¹⁷³.

In other words, like *musharaka* transactions, even in *mudaraba* ones a financial institution provides capital to an entrepreneur¹⁷⁴, with the

¹⁶⁹ M. TAQI USMANI, *An Introduction to Islamic Finance*, Idaratul Ma'arif, Karachi, 2000, p. 12.

¹⁷⁰ H. VISSER, *Islamic Finance*, cit., p. 54.

¹⁷¹ H. VISSER, *Islamic Finance*, cit., p. 54; G. BILAL, *Islamic Finance*, cit., p. 156. The bank also acts as a *mudarib* when investing the depositors' money, assuming the role of their agent.

¹⁷² See H.M. SHARAWY, *Understanding the Islamic*, cit., p. 169 ("In exchange for the use of the capital, the entrepreneur agrees to give a specified share of future profits to the investors, who in turn are exclusively responsible for any loss to the capital while in the care of the entrepreneur"). See also H. VISSER, *Islamic Finance*, cit., p. 54.

¹⁷³ M. TAQI USMANI, *An Introduction*, cit., p. 14.

¹⁷⁴ I. WARDE, *The Relevance of Contemporary Islamic Finance*, in *Berkeley Journal of Middle Eastern and Islamic Law*, n. 2/2009, pp. 159-171. The *mudaraba* is also known as *commenda* partnership. More in detail, it is an association between the *rabb-el-maal* (financier) and the



important difference that the financial institution provides all the capital, while the customer provides only labour and expertise¹⁷⁵.

The customer/entrepreneur serves the financial institution as its agent (*mudarib*), with the commitment to manage the funds in the venture¹⁷⁶.

c) *Murabaha* (Financing on a Cost-Plus Basis)

One of the most typical financial instruments is the *murabaha*, which actually constitutes a contract of sale¹⁷⁷.

In this very case the bank plays the role of an intermediary and purchases the item desired by its client; then, in a second moment, the same financial institution resells that item to its client at the purchase cost plus a mark-up¹⁷⁸. The seller is obliged to reveal to the buyer the cost of the good requested. If such price cannot be known in advance, the contract changes and becomes *musawama*: namely, the mark-up is decided without a precise landmark. The customer usually agrees to pay the item in installments¹⁷⁹.

mudarib (entrepreneur) where, on the liability side, the depositor is the *rabb-el-maal* and the bank is the *mudarib*, while, on the asset side, the bank is the *rabb-el-maal* and the client is the *mudarib*. It is a sort of a double *mudaraba* principle.

¹⁷⁵ See I. WARDE, *The Relevance*, cit., pp. 18-19.

¹⁷⁶ A parallel is visible with the Talmudic law where this kind of contract - called *palga milveh u'palga pikadon* (PMUP) - is characterized by an egalitarian approach since 50 per cent of the investment come from the financier and 50 per cent from a loan to the entrepreneur. Furthermore, since it is clear that a lender-creditor relationship is in force, and, in order not to violate the law of *ribbit*, the financier pays the managing partner a salary, (even a symbolic one dollar). This condition is not required by the *sharia*. See M.H. LUBETSKY, *Losing Interest*, cit., p. 253. A salient feature of this kind of contract is that, since a PMUP contract cannot guarantee the level of profit/repayment of the principal, parties can envisage a clause in which the expected profit is indicated. If the recipient claims a loss, the PMUP may require: 1) to take a solemn oath in front of a Jewish court or the entire synagogue, and/or 2) to produce a high number of witnesses testifying to the loss. However, because of the fear of the Orthodox Jews to mention the name of the Lord in vain, the 'oath clause' practically converts the PMUP into a fixed-return contract: the *heter iska*. "The proliferation of the *heter iska* reveals how Jewish law, a formalist and actualizing tradition, takes a permissive approach to interest-avoiding transactions once they reach a certain level of complexity" (M.H. LUBETSKY, *Losing Interest*, cit., p. 254).

¹⁷⁷ G. BILAL, *Islamic Finance*, cit., p. 153.

¹⁷⁸ See A. BANAGA, G.H. RAY, C. TOMKINS, *External Audit*, cit., p. 13.

¹⁷⁹ See G. BILAL, *Islamic Finance*, cit., p. 153, and H. VISSER, *Islamic Finance*, cit., pp. 57-58.



It is normal practice to transfer directly the asset to the client (even if the financial institution is the buyer) in order to avoid transaction costs¹⁸⁰. In line with this habit, Islamic banks often authorize the customer to act as the bank's agent to permit the asset's transfer in its own name. It is worth mentioning that, despite some criticism, this instrument accounts for over seventy percent of the Islamic financial transactions¹⁸¹.

d) *Ijara* and *Ijara wa iqtina* (Lease Financing)¹⁸²

The concept of leasing is represented in the Islamic world by the *ijara*, where a financial institution "purchases an asset and leases it to a Client"¹⁸³.

In the most typical epiphany the bank has ownership of the assets during the lease period; while, on the other side, the client owes a rental fee. With regard to the equipment, the financial institution owns the asset throughout the lease period and the customer pays the financial institution a rental fee¹⁸⁴.

The client maintains the right to buy the item leased throughout the leasing period or at the end of the lease itself, without being obliged to do so¹⁸⁵ and, at the same time, without any guarantees that the bank will sell

¹⁸⁰ P. MOLYNEUX, M. IQBAL, *Thirty Years of Islamic Banking: history, performance and prospects*, Palgrave Macmillan, New York, 2005, pp. 169-170.

¹⁸¹ H. VISSER, *Islamic Finance*, cit., pp. 57-58. See also J.C.T. CHUAH, *Islamic Principles Governing International Trade Financing Instruments: a Study of the Murabaha in English Law*, in *Northwestern University Law Review*, n. 27/2006, p. 137 ff.

¹⁸² "Halakha and shari'ah both allow rental contracts. However, the *ijara* contract used in Islamic banking has dubious legality in halakha due to the promise to remit the item to the borrower upon the conclusion of the contract" (M.H. LUBETSKY, *Losing Interest*, cit., p. 252-253). One solution elaborated by the practice of Talmudic legal scholars/experts is a mixed sale-lease agreement, where the financier purchases the item and sells it back, fraction-by-fraction, to the purchaser. In this way, the financier has the legitimate prerogative to charge the co-owner rent for the use of its remaining fraction. The final outcome - in practical terms - recalls the *ijara* (even if the co-ownership and the mixed purchase-rental payments increase the level of elaboration and complexity). M.H. LUBETSKY, *Losing Interest*, cit., p. 253.

¹⁸³ I. PERVEZ, *Islamic Banking*, cit., p. 23.

¹⁸⁴ See G. BILAL, *Islamic Finance*, cit., p. 154. See H.M. SHARAWY, *Understanding the Islamic*, cit., p. 171.

¹⁸⁵ G. BILAL, *Islamic Finance*, cit., p. 154. The difference between the two lies in the fact that *ijara*: 1) a lease/hire begins the day the asset is delivered to the client and not when the contract is signed; 2) the lessee is not liable for the full rent if the asset is destroyed; and 3) the purchase at the end of the contract cannot be made binding.



him the good. Such sales can be agreed on between the parties in a separate contract¹⁸⁶.

In *ijara wa iqtina* the lessee pays installments that include a portion of the final sale price of the item. In this way the customer acquires the right to buy the item at a predetermined price when the lease period comes to an end¹⁸⁷.

e) *Qarde Hasan* (Benevolent Financing)

Financial assistance to charitable institutions or carried out for humanitarian purposes is provided with free-of-charge loans through the so-called *qarde hasan*¹⁸⁸.

But, notwithstanding the intentions declared, the following requirement must be met: the beneficiary of the loan signs an unconditional obligation of repayment and, as often happens, a collateral is also required¹⁸⁹. Sometimes, some small administrative costs are foreseen for the beneficiary¹⁹⁰.

¹⁸⁶ See **I. ABDAL-HAQQ**, *A Model of Islamic Banking and Finance in the West: IslamiQ*, in *Journal of Islamic Law and Culture*, n. 6/2001, p. 101, where the Author presents IslamiQ as an emerging Islamic banking and financial services organization. In particular, then, it is described that, even if leasing has been adopted by many Islamic financial institutions, few of them have paid attention to the fact that a 'financial lease' has a number of characteristics more similar to interest than to an actual lease transaction. Since the difference between an interest-based financing and a lease does not lie in the amount paid to the financier (lessor, even though the amount of the rent claimed from the lessee is equal to the rate of interest), the Author suggests that the lessor, after entering into a lease agreement, can sign a separate unilateral promise undertaking that if the lessee has paid the full amount of the rent due, and wishes to purchase the asset at a specified price, the leased asset will be sold at that price.

¹⁸⁷ For *amplius*, see **H. VISSER**, *Islamic Finance*, cit., pp. 59-60. The structure of this kind of operations resembles the conventional mortgage; here, the borrower in general does not actually see the money used to purchase the good. See **M.M. TOMEH**, *Persuasion and Authority*, cit., pp. 153-154, the Author properly describes this kind of transaction: «Rather, the lender pays the purchase price to the title company which then transfers the money to the seller (or lender). The loan is tied to some tangible asset, such as a home or a car. From the perspective of the mortgagor, he never sees the money he "borrowed". The mortgagor gets a house (not cash), for which he pays a monthly payment and, at the end of a term, owns the house"». **M.A. El-Gamal** notes that the distinctions between a conventional mortgage and many ostensibly 'Islamic' finance solutions are illusory. See **M.A. EL-GAMAL**, *Islamic Finance*, cit., p. 48.

¹⁸⁸ See **I. PERVEZ**, *Islamic Banking*, cit., p. 23.

¹⁸⁹ See **I. PERVEZ**, *Islamic Banking*, cit., p. 23.

¹⁹⁰ See **A. BANAGA, G.H. RAY, C. TOMKINS**, *External Audit*, cit., p. 16.



In accordance with the Islamic approach to economics, *qarde hasan* “are for the benefit of the individual and the society at large”¹⁹¹. According to their peculiar nature, such activities “do not constitute a significant source of financing by Islamic banks”¹⁹².

f) *Istisna* (Manufacturing Contract)

Parties enter into a manufacturing contract for a specified product; payments are made as the product becomes closer to completion, so they depend on the work progress¹⁹³.

Islamic finance institutions use this contract form to finance a manufacturing project which will involve two different manufacturing contracts: the first one is between the party advancing a manufacturing request and the bank, and encompasses the price the client will pay, usually in installments, and the agreed date of delivery of the product the bank will provide¹⁹⁴; the second contract, instead, is a contract between the bank and the manufacturer which will produce and deliver the item bargained for¹⁹⁵.

g) *Bai'salam* (Forward Sale)

Bai'salam is a sale contract where parties agree to a future delivery for a price paid in advance¹⁹⁶. This financial instrument constitutes a sort of exception: forward contracts are generally not permissible because one should not sell what he does not possess¹⁹⁷.

¹⁹¹ S.H. SIDDIQUI, *Islamic Banking: genesis and rationale, evaluation and review, prospects and challenges*, Royal Book Company, Karachi, 1994, p. 53.

¹⁹² S.H. SIDDIQUI, *Islamic Banking*, cit., p. 53.

¹⁹³ S.H. SIDDIQUI, *Islamic Banking*, cit., p. 173.

¹⁹⁴ S.H. SIDDIQUI, *Islamic Banking*, cit., p. 173.

¹⁹⁵ S.H. SIDDIQUI, *Islamic Banking*, cit., p. 173.

¹⁹⁶ The so called *emptio rei speratae*. See A. LUMINOSO, *La compravendita. Corso di Diritto Civile*, Giappichelli, Turin, 2011, p. 79.

¹⁹⁷ This kind of technique “has a vast potential to finance productive activities in crucial sectors, particularly agriculture, agro-based industries and the rural economy as a whole. It also provides an incentive to enhance, as the seller will spare no effort to produce at least the quantity needed for settlement of the loan taken by him as the advance price of the goods. It could be also useful for the creation of a stable commodities market, especially of seasonal commodities. It enables savers to direct their savings to investment outlets, without waiting, for instance, until the harvesting time of agricultural products or the time when they actually need industrial goods and without being forced to spend their savings on consumption” (http://www.islamic-banking.com/profit_and_loss_sharing.aspx. Last visited 13 October 2016).



For this reason, even if *bai'salam* is recognized by the *sunna* itself¹⁹⁸, it is not available for every commodity and it is restricted to agricultural products, fungibles and to providing some capital to small traders¹⁹⁹.

h) *Takaful* (Islamic Insurance)

Islamic insurance²⁰⁰ industry developed in an unconventional way²⁰¹. Even if Islamic law recognizes the need to protect against loss deriving from natural calamities and acknowledges risk taking as part of the entrepreneurial spirit, the fact that commercial insurance is an aleatory contract makes this kind of transaction not well accepted by the Islamic traditional jurists²⁰². Abbas Husni Mohamed says that the criterion for the condemnation of the commercial insurance contract under Islamic *sharia* is clearly the involvement of *jahala*, *gharar*, usury, gambling or wagering rather than the lack of interest of any of the parties to the contract in the subject-matter of insurance²⁰³.

¹⁹⁸ See H. VISSER, *Islamic Finance*, cit., p. 61.

¹⁹⁹ F.E. VOGEL, S.L. HAYES, *Islamic Law*, cit., p. 225, and H. VISSER, *Islamic Finance*, cit., pp. 61-62.

²⁰⁰ Since Islamic finance, in general, places special emphasis on social welfare as a criterion of business practice almost discouraging wealth maximization, Islamic insurance is meant to be a cooperative model of insurance (H. MASUD, *Takaful: an Innovative Approach to Insurance and Islamic Finance*, in *University of Pennsylvania Journal of International Law*, n. 32/2011, p. 1133).

²⁰¹ For an overview of the recent developments of the Takaful market, see S. JAFFER, *Banca Takaful challenges and opportunities*, in *Islamic Finance Review* (2009-2010).

²⁰² See P. MOLYNEUX, M. IQBAL, *Thirty Years*, cit., p. 160 (listing three forms of risk: first, the "entrepreneurial risk" that arises in the normal course of business; second, the risk of natural disasters; and third, the unnecessary, self-created risk that arises when people play "games"). The Author suggests that the first two types of risk are inherent in daily life and must be addressed. Id. (clarifying that "games", which create risks that are not part of daily life, are unnecessary for the individual because the individual could avoid them by choosing not to play them and are unnecessary for society because they do not contribute to societal wealth). These "games" are equitable to gambling, which Islam prohibits.

²⁰³ S. MANKABADY, *Insurance and Islamic Law. The Islamic Insurance Company*, in *Arab Law Quarterly*, n. 4/1989, p. 199; R. MAHMOOD, *Takaful: the Islamic System of Mutual Insurance - the Malaysian Experience*, in *Arab Law Quarterly*, n. 6/1991, p. 280; M.M. BILLAH, *A Model of Life Insurance in the Contemporary Islamic Economy*, in *Arab Law Quarterly*, n. 12/1997, p. 287; M.B. ARBOUNA, *The Operation of Retakaful (Islamic Reinsurance) Protection*, in *Arab Law Quarterly*, n. 15/2000, p. 335; R.I. BEKKIN, *Islamic Insurance: National Features and Legal Regulation*, in *Arab Law Quarterly*, n. 21/2007, p. 3.



Such principles need to be interpreted by taking into account that the Islamic *shari'ah* requires the internalization of absolute good faith in transactions.

Islamic Law regards these contracts as *Uberrimae Fidei* contracts (*ugud amana*), or, in other words, it considers them as *contracts of good faith*. In these contracts the buyer trusts the seller to tell him the original price with no need for proof.

The doctrine has argued in favour of cooperative insurance as a substitute for commercial insurance. Consequently, the insurance company follows the PLS criteria, sharing with a pool of policy holders the mutually agreed risk to cover each other in case of loss²⁰⁴. The fees of the insurance company, in this way, are not seen as a premium paid for the insurance to the policy holders but as a sort of a management fee to carry on the business. These contributions are pooled into a common fund and invested according to *shari'ah*-compliant investment options. According to this structure, the Islamic insurance company does not provide any assurance/insurance to the policy-holders, but acts on their behalf to manage the business. The members agree that if any of them suffer a covered loss, then each will make a proportionate gift from their accounts to cover that loss.

The acceptance of this contract is to be found in the belief that gratuitous acts permit a higher degree of uncertainty, and, in addition, that gift promises can be binding. In that way, the insurance pool is more similar to a charitable institution, since it carries on the business as a cooperative on behalf of its members (the fund is simply managed by a corporation, while the actual ownership lies with the participants in the fund who must pay out claims²⁰⁵): profits are shared by the policy holders rather than given to third-party shareholders²⁰⁶.

This is in strict accordance with the Islamic ideals of welfare and charitable giving: "the system is a collective enterprise that allows a community to pool together resources in order to assist members of the community in times of need resulting from casualty or loss"²⁰⁷.

²⁰⁴ See **M.M. BILLAH**, *Islamic Insurance: its Origins and Development*, in *Arab Law Quarterly*, n. 13/1998, p. 386, explaining that it is acceptable to protect oneself against suffering, but it is improper to profit from that suffering and, as such, the Islamic insurance industry was developed around the idea of taking care of one another.

²⁰⁵ **H. MASUD**, *Takaful: an Innovative*, cit., p. 1144.

²⁰⁶ **H. MASUD**, *Takaful: an Innovative*, cit., p. 1143, also in the Takaful model, there is a *shari'ah* board that regulates the *takaful* company to ensure that products being offered by the company are consistent with Islamic law.

²⁰⁷ **H. MASUD**, *Takaful: an Innovative*, cit., p. 1142.



The profit is the final outcome of the gross revenue minus the payment of any claim: the surplus will be shared among the investors (company and policy holders) according to a predetermined formula.

And, accordingly to the literal meaning of *takaful* ("solidarity"), this institution tends to protect the members from any loss.

Clearly, there is a difference in the ratio between conventional and Islamic insurance: while the former seeks to eliminate risk for the individual, the latter pursues the same aim, but in reference to a community²⁰⁸.

i) *Sukuk* (Islamic Bonds or Debt Securities)

Sukuk, literally a plural form of *saak* (title or investment certificate), is of ancient origins²⁰⁹: in its contractual form it existed at least from the seventh century²¹⁰. These days, the market globalization is increasingly enhancing

²⁰⁸ H. MASUD, *Takaful: an Innovative*, cit., p. 1142. One problematic aspect regarding *takaful* operations concerns the capital adequacy requirement, which is necessary in many countries. E. GROSSMAN, *The Human*, cit., p. 1033. "Regardless of whether *takaful* is just an exercise in creative labeling, Muslim societies around the world have, over the past three decades, exhibited a trend of openly validating *takaful* and even, in some instances, have institutionalized the system on a national scale". Just to quote some examples, see, the 1995 Qatar established the Qatar Islamic Insurance Company, the 2005 Saudi Arabian Monetary Agency (SAMA) Regulations for cooperative insurance, the 2005 Bahrain Monetary Authority Rules regulating *takaful* companies, and the 2010 Accounting and Auditing Standards for Islamic Financial Institution Islamic Insurance Standard No. 26. See, R.I. BEKKIN, *Islamic Insurance: National Features and Legal Regulation*, in *Arab Law Quarterly*, 21/2007, pp. 113-14, discussing how the Islamic insurance system relies on the concept of gift-giving to avoid *gharar*. See also A. KHAN, *Islamic Insurance: Evolution, Models and Issues*, in *Policy Perspective*, 13/2016, pp. 29, 30-32 (describing the development of *takaful* systems within various countries).

²⁰⁹ However, according to J.E. McKEAN, *The Future of Conflict Between Islamic and Western Financial Systems: Profit, Principle and Pragmatism*, in *University of Pittsburgh Law Review*, n. 71/2010, p. 819, the modern *sukuk* appeared in Bahrain in 2001 and in Malaysia in 2002.

²¹⁰ R. HANEEF, *Recent Trends and Innovations in Islamic Debt Securities: Prospects for Islamic Profit and Loss Sharing Securities*, in *Islamic Finance: Current Legal and Regulatory Issues*, edited by S.A. Nazi, The Islamic Finance Project, Islamic Legal Studies Program, Harvard Law School, Cambridge, 2005, pp. 29-30. The Author explains that Soldiers and other public officials were paid in cash, as well as in kind. «The payment in kind was in the form of [...] "commodity coupons" or "grain permits" (both *sukuk*) that were entitled for the promised quantity of the commodity (usually grains) upon maturity of the coupons or permits, as the case may be. In 2001, fourteen centuries later, the practice of *sukuk* was revived: the Kingdom of Bahrain issued USD \$ 250 million with five years of maturity». K.I. TALAHMA, *Islamic Bonds (Sukuk): Opportunities and Challenges*, in *Asper Review of International Business and Trade Law*, n. 15/2015, p. 422, states that: "[t]here is a clear lack of



the spread of the *sukuk* agreement²¹¹ in practice, as well as making it more and more complex²¹² in order to follow the evolution of international transactions²¹³.

The structure of the *sukuk*, that is an asset-backed instrument, in extreme synthesis, equals that of a bond issue while remaining compliant with the *Sharia*, as the investor will not receive any predetermined interest rate, even if they are granted an income with a good degree of certainty. In a very often spread formula, *sukuk* are associated to real estate assets corresponding to the ownership of those assets²¹⁴. However, when *sukuk* is used to guarantee purchasers interest-free loans and repurchase agreements in case of missed payments or default, it violates the *gharar* restrictions and, so, is not *sharia*-compliant, as investor's returns are linked to the creditworthiness of the issuer instead of the value of the underlying assets²¹⁵.

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) issued the Standard for Investment *Sukuk* (Standards)

any legislative framework capable of regulating the issuance of Islamic bonds (*sukuk*), listing them and trading in them in some Islamic countries. This has resulted in a lack of uniformity in the transactions related to this instrument. Different jurisdictions have conflicting visions of how Islamic bonds should work. Some of these differences stem from alternative viewpoints as to the applicable jurisprudence and confusion between religion and politics in matters that should be left to experts in the fields of economics investment and management”.

²¹¹ See **A.H.A. KHALEQ, P. DOWSETT**, *Managing Sukuk in the current climate: Moving the goalpost and calling time*, in *Islamic Finance Review*, 2009-2010, for a good analysis of the recent developments of this financial instrument. The Author s underline the dramatic contraction of the *Sukuk* market in 2008 and try to explain the reasons behind it.

²¹² See **A.H. ABDEL-KHALEQ, C.F. RICHARDSON**, *New Horizons for Islamic Securities: Emerging Trends in Sukuk Offerings*, in *Chicago Journal of International Law*, n. 5/2007, p. 409, according to whom this complexity derives from applicable laws regarding bankruptcy, tax, trusts, corporations, securities regulations, real property, and secured transactions that all influence the proper structuring and documentation of asset-backed *sukuk* transactions in non-Islamic jurisdictions that are marketed to investors outside the Muslim world or issued by entities located in non-Islamic states.

²¹³ See **M.A. EL-GAMAL**, *Islamic Finance*, cit., pp. 11-13 (discussing the role of financial providers, jurists, and lawyers in the development of IFS products and explaining that when a product is first developed, it has a captive market and is very profitable, but then is easily replicated, reducing its profit margin).

²¹⁴ See **H. VISSER**, *Islamic Finance*, cit., pp. 63-64.

²¹⁵ **S.R. ANDERSON**, *Recent Development: Forthcoming Changes in the Shari'ah Compliance Regime for Islamic Finance*, in *Yale Journal of International Law*, n. 35/2010, p. 237.



in 2003²¹⁶. The AAOIFI Standards do not treat *sukuk* as debts of the issuer, but as “fractional or proportional interests in underlying assets, usufructs, services, projects, or investment activities”²¹⁷.

The main differences with traditional bonds are that *sukuk* “represent an ownership interest on the part of the holders in the enterprise underlying the issue of the *sukuk*”²¹⁸, pay out returns based on the performance of the underlying asset²¹⁹, and, imply a binding promise made by the asset manager to repurchase the *sukuk* at the same price of the original sale²²⁰.

j) *Damanah* (Third-Party Guarantee)

Islamic law allows a third party to serve as a guarantor to the contracting parties. The guarantor, however, can only charge for its administrative expenses, and not for the cost of capital²²¹.

Owing to compensation restrictions, these guarantors only sponsor entities such as the government or holding companies. The guarantor also holds a lien on the contract assets²²².

k) *Ba'i Bithaman Ajil* (Deferred Payment Financing)

Ba'i bithaman ajil involves a credit sale of goods on a deferred payment basis²²³. At customer request, the financial institution purchases an existing contract in order to buy certain assets on a deferred payment schedule and

²¹⁶ See **M.J.T. McMILLEN**, *Sukuk (Islamic Bonds and Securitization): Toward a Viable Capital (Including Secondary Market)*, in *Integrating Islamic Finance in The Mainstream: Regulation, Standardization and Transparency*, edited by S.A. Nazi, The Islamic Finance Project, Islamic Legal Studies Program, Harvard Law School, Cambridge, 2007.

²¹⁷ **M.J.T. McMILLEN**, *Contractual Enforceability Issues: Sukuk and Capital Market Development*, in *Chicago Journal of International Law*, n. 7/2007, p. 429.

²¹⁸ See **J.E. McKEAN**, *The Future*, cit., p. 819.

²¹⁹ **J.E. McKEAN**, *The Future*, cit., p. 819. From an operative standpoint, it means that *sukuk* is provided by an additional agreement in which the holder is entitled to returns at a certain percentage (based on LIBOR interest rates). Following the performance, then, if the assets underperform, the manager of the asset will pay out the difference in the form of an interest-free loan; otherwise, the surplus will be recovered by the manager to pay the loans; but, in this case, it is possible to include a bonus for the manager in case such loans have not been concluded.

²²⁰ Instead, in a traditional bond, upon the maturity, the holder is - regardless of the performance of the underlying asset - entitled to the return of the principal. This difference is based on the fact that *sharia* principles ask for a return based on the performance of the underlying asset (Id).

²²¹ **F.E. VOGEL, S.L. HAYES**, *Islamic Law*, cit., p. 221.

²²² **F. E. VOGEL, S.L. HAYES**, *Islamic Law*, cit., p. 221.

²²³ **G. BILAL**, *Islamic Finance*, cit., p. 154.



then, it sells those goods back to the customer at an agreed-upon price, including also a profit.

The payments to the original supplier of the goods are progressively made by the financial institution, as the goods are manufactured or purchased. The financial institution's customer "can repay in lump sum or make installment payments over a predetermined period"²²⁴.

l) *Bai inah* (Repurchase by seller)

Bai inah consists in a particular kind of repurchase by the seller²²⁵. The contracting parties are the buyer, a customer, and the seller, a bank or other financial institutions. The customer buys something on credit from the financial institution and then sells it back to the bank itself. The second sale will be at a lower price than the first one and the bank will provide immediate payment. This archetype could be applied to every credit transactio²²⁶.

Scholars are divided on this contractual practice and some of them consider it *haram*²²⁷.

m) *Tawarruk* (Monetization method)

Tawarruk is another debated Islamic financial instrument, whose compliance with *Shari'a* principles is not clear of doubts.

This contract usually involves three parties: one party buys something on credit from a second party and sells it to a third one which pays immediately²²⁸. In other words, the financial institution trades in

²²⁴ G. BILAL, *Islamic Finance*, cit., p. 154.

²²⁵ See H. VISSER, *Islamic Finance*, cit., p. 69.

²²⁶ Compared with Talmudic law, it considers as *ribbit d'rabbanan* a wide number of credit-extending practices, making the most common transactions in Islamic finance unacceptable. The general rule is that a businessman cannot charge different prices for cash, credit, or advance payment sales. This simple statement would have the effect to render the already analyzed *bai' bithaman ajil*, *murabaha*, *tawarruq*, and *bai' al-'ina*, ineffective under Rabbinic legislation since they violate the no-charge interest transaction principle (M.H. LUBETSKY, *Losing Interest*, cit., p. 252).

²²⁷ See H. VISSER, *Islamic Finance*, cit., p. 69.

²²⁸ Another similar situation occurs when a person joins an association, makes regular contributions, and, after a certain period of time, takes out a *qard hasan* (interest-free loan). The simple schema just described is an effective financial technique to organize credit within a community recalling the nineteenth century credit cooperatives. Furthermore, it is similar to the social idea of Islamic banking, where the *cooperative*, or *communal*, or *co-operational* element is seen as a relevant feature. Obviously, the backlash of this financial structure is the limited economical relevance, depending on the people forming a local community. "In addition, it depends on personal trust and is not suited for the «industrialized» business of retail banking". K. BALZ, *Islamic Finance for European Muslims*:



commodities on behalf of its client, who receives funds for their own purpose. At a formal level, this operation looks like a conventional consumer finance transaction, but, from the financial institution point of view the transaction is here asset-based²²⁹.

Tawarruk is often used when a subject, often a financial institution or an entrepreneur, needs liquid funds. As anticipated, some scholars consider this form of contract as *hiyal*, a legal stratagem used to avoid Koran's prescriptions²³⁰.

14 - Islamic Finance

The origins of Islamic finance date back to the days when the camel caravans used to cross the trade routes and the Arabian deserts. The simplified business plan of that time saw a wealthy merchant providing money to traders (bearing the risk to purchase goods and to carry them) in exchange for a remuneration, if the caravan had positively completed its round, but with the associated risk of a loss if the caravan had got lost or been robbed during its journey.

This kind of agreement was welcomed by *sharia* because, on the one hand, it respected the prohibition of lending money with an interest rate, and, on the other hand, by allocating the risk (a reward or a loss are shared by the participants), it encouraged the businessmen to transform unproductive resources into productive ones²³¹.

This equity-participation system was not unknown to the Western financial tradition, as it had been proposed at various times during economic crises in the United States and Latin America.

the Diversity Management of Shari'ah-Compliant Transactions, in *Chicago Journal of International Law*, n. 7/2007, p. 560.

²²⁹ In the very common purchase of a car, e.g., the bank will not be involved in the purchase; instead, it will carry out a commodity transaction, operation whose risk is much easier to allocate. This schema can - with a certain degree of success - be applied to consumer credit in general, even if the Islamic legitimacy of *tawarruq* transactions remains disputed since a substantive approach to Islamic banking principles requires the financial institution to take on business risk and to be involved in the concrete transaction (K. BALZ, *Islamic Finance*, cit., pp. 560-561).

²³⁰ See H. VISSER, *Islamic Finance*, cit., pp. 69-70.

²³¹ A. BERSCHADSKY, *Innovative Financial Securities in the Middle East: Surmounting the Ban of Interest in Islamic Law*, in *University of Miami Business Law Review*, n. 9/2001, pp. 109-110.



While these principles were used as the basis for a flourishing economy in earlier times, it was only in the late 20th century that a number of Islamic banks were formed to provide an alternative basis to Muslims, although Islamic banking is not restricted to Muslims alone.

This economic context radically changed in the seventies owing to the oil boom flooding the State's coffers and the cash desks of the oil producing countries of the Middle East. From that moment, since the savings were becoming more and more relevant, the call for fruitful investments has increased. But, of course, everything should have been done according to *sharia* (the founding Islamic principles on finance are influenced by historical and economical changes so that, although these principles are not completely unknown, presumably, their original meaning has been transformed over the epochs)²³².

Therefore, the modern Islamic finance is a recent phenomenon; it began in 1963 in Egypt under Ahmad El Najjar who set up an Islamic bank under the guise of a savings bank (interest free) so as not to upset the secular Egyptian government²³³. This bank was founded in Mit Ghamr, a rural and highly religious area in Egypt, and this enlightened project was carried out to allow the inhabitants to use their savings (had not the project been *sharia*-complaint, they would have never placed their savings in any bank) and to be educated about the uses and purposes of banks²³⁴.

The Mit Ghamr project was successful, as deposits increased from 1963 to 1966. The bank was cautious, rejecting about 60% of the loan applications and the default *ratio* was zero in economically good times. The Nasir Social Bank fully disclosed its activity in 1971²³⁵.

²³² G.M. PICCINELLI, *Banche islamiche in contesto non islamico. Materiali e strumenti giuridici*, Ipocan, Rome, 1994.

²³³ The recent development of Islamic finance is a reaction to the globalization of financial markets and to the spread of Western financial institutions throughout the world's economies, which are able to cross the borders of the Muslim world. However, it is also part of a larger trend started in the 1970s aimed at reintroducing Islamic law in many Muslim countries. Notwithstanding this tendency, the influence on laws and institutions derived from the Western legal systems remains the dominant one. H. MASUD, *Takaful: an Innovative*, cit., p. 1133.

²³⁴ The types of accounts accepted are: (i) Savings accounts; (ii) Investment accounts; (iii) Zakat accounts. No interest was paid on savings accounts, but withdrawals could be made on demand. Small, short-term, interest-free loans for productive purposes could be made. Funds in investment accounts were subject to restricted withdrawals and invested on the basis of profit-sharing.

²³⁵ M.S. BILLAH, *Arab Money: why Isn't The United States Getting Any?*, in *University of Pennsylvania Journal of International Law*, n. 32/2011, p. 1066. But the project was eventually



Then, a second wave of impulse for the modern Islamic Finance began with the recession of colonialism and the Muslim self-identification: the Philippine Amanah Bank was established in 1973, the Dubai Islamic Bank in 1975, the Faisal Islamic Bank of Egypt in 1977, the Faisal Islamic Bank of Sudan in 1977, the Bahrain Islamic Bank in 1979, and the Malaysian Muslim Pilgrims Savings Corporation in 1983²³⁶.

The modern Islamic Finance entered the Western marketplace in 1978 when the Islamic Banking Systems (now Islamic Finance House) was established in Luxembourg²³⁷.

"Today, there are over three hundred Islamic financial institutions in seventy-five countries, one-fourth of which operate in countries with non-Muslim majority populations"²³⁸.

Today, the popularity of this form of finance seems to be increasing since the leading principles on which Islamic finance is based (namely, the requirement that investments and financings be tied to productive assets and speculative investments be avoided as well as the sharing of risks in projects' development) have played an important role in limiting the negative effects of the ongoing financial crisis on the investors, who need not worry about illusory profits which could be wiped out by currency fluctuations or the decline in value of option or futures contract²³⁹.

The current trend, given this premise, has been characterized by a flow of resources into Islamic mutual funds since the investors perceive a higher degree of safety in the *sharia*-compliant financial products avoiding the stocks of financial institutions and companies that have been highly leveraged and, moreover, because Islamic institutions are assumed not to be holding toxic assets as opposed to conventional banks²⁴⁰.

abandoned for political reasons. Nevertheless, it had shown that commercial banking could be organised on a non-interest basis.

²³⁶ These data are drawn from **M.S. BILLAH**, *Arab Money*, cit., p. 1066. The same Author underlines that Islamic banks were established in Iran and Pakistan in a subsequent moment.

²³⁷ **M.S. BILLAH**, *Arab Money*, cit., p. 1066. Then, the Islamic Bank International (Copenhagen), Islamic Investment Company (Melbourne), and the Citi Islamic Investment Bank (Bahrain) followed.

²³⁸ **M.S. BILLAH**, *Arab Money*, cit., pp. 1066-1067.

²³⁹ This basic structure has been used in syndicated financing facilities for *sharia*-compliant companies on a regular basis, but this financing arrangement has become more prominent as the *sukuk* capital markets contracted (**G. BILAL**, *Islamic Finance*, cit., p. 145).

²⁴⁰ **I. SALAH**, *Islamic Finance in the Current Financial Crisis*, in *Berkeley Journal of Middle Eastern and Islamic Law*, n. 2/2009, p. 137.



Nevertheless, it has to be said that Islamic finance has not been immune to the pressures caused by the globalized financial crisis²⁴¹.

Indeed, beyond the differences already highlighted, parallels with conventional finance abound: in both cases, in fact, due diligence is carried out to evaluate the client's creditworthiness; the purchased asset serves as a collateral (and other sureties can be additionally required by the banks); and, when the bargain is concluded the client becomes a debtor of the bank²⁴².

Even if the Islamic finance has been able to manage quite safely the subprime and swap debacle started in the 2008 (thanks, as already mentioned, to the tenets of its own financial system, e.g. the securitization of debt the avoidance of the bets inherent to credit default swaps, the excessive leverage, and more generally the sheer complexity and opacity of the derivatives and their distance and disconnection from real assets and so on), it has been affected by a 'second level bubble', the one caused by a fall in asset prices (see, e.g., oil, real estate, shares etc.)²⁴³.

This financial slowdown has been concealed by the incredibly high growth rates of Islamic banks (that, in the last decades, reached double digits, and increased by 26% in 2006 and by 38% in 2007)²⁴⁴.

Furthermore, though it is not possible to provide the precise dimension of this sector, it is worth mentioning that there are over 250 banks operating worldwide that offer Islamic banking services, with an aggregate of over 200 billion U.S. dollars in deposits²⁴⁵ and that the Islamic finance industry is estimated to be valued at \$ 1 trillion and expected to grow up to \$ 2.8 trillion by 2015²⁴⁶.

²⁴¹ **I. SALAH**, *Islamic Finance*, cit., p. 137: "On a transactional level, shari'ah-compliant investments have responded in a manner quite comparable to conventional transactions, largely because the financing for those transactions is often indirectly funded with conventional financing".

²⁴² See **I. WARDE**, *Corporate Governance and Islamic Moral Hazard*, in *Islamic Finance: Current Legal and Regulatory Issues*, edited by A. Nazim, Islamic Finance Project, Islamic Studies Program, Harvard Law School, Cambridge, 2005, and, more recently, see **I. WARDE**, *The Relevance*, cit., pp. 159-171.

²⁴³ **I. WARDE**, *The Relevance*, cit., pp. 159-171.

²⁴⁴ **I. WARDE**, *The Relevance*, cit., p. 166. The Author pertinently suggests that Islamic finance has been going through constant changes, due to "changing political-economic context, dynamics of interaction with the conventional sector, and more broadly as the result of processes of trial and error".

²⁴⁵ **H. AHMED**, *Not Interested*, cit.

²⁴⁶ **M.M. TOMEH**, *Persuasion and Authority*, cit., pp. 153-154.



Related, instead, to the geographical spread, Islamic banking services are provided not only by the predominantly Muslim countries but also by those where the Muslim population is the minority. Australia, Italy, Russia, South Africa, Switzerland, and above all the U.K - currently considered the hub for this service²⁴⁷ - have found it useful to meet the banking needs of their resident Muslim population²⁴⁸.

The idea to make the interests of all stakeholders of a financial transaction (namely, depositors, financial institutions and entrepreneurs) converge - giving the bank the role of a private venturer - seems very promising.

If such idea is combined with the Islamic financial rule to bring economic benefits to the society at large (by means of the circulation of savings, the propulsion of productive investment and the general economic welfare), the result is a socioeconomic system potentially alternative to Wall Street's laissez-faire one²⁴⁹.

This structure can be more easily accepted because modern Islamic financial practice is no longer a strictly 'traditional' one, since it has been implemented and modified in the course of time.

This sentence is not to be intended drastically: in simple words,

"this does not mean that Islamic finance is indistinguishable from the current financial trends. It is still a unique approach that fulfills a dual purpose: granting Muslims an alternative to traditional financial instruments, while making these instruments an attractive option in modern economies"²⁵⁰.

²⁴⁷ **S.M. NIZAMI**, *Islamic Finance: the United Kingdom's Dive to Become the Global Islamic Finance Hub and the United States' Irrational Indifference to Islamic Finance*, in *Suffolk Transnational Law Review*, n. 34/2011, p. 219.

²⁴⁸ **H. AHMED**, *Not Interested*, cit. But see, e.g., **M. SILVA**, *Islamic Banking Remarks*, in *Law and Business Review of the Americas*, n. 12/2006, p. 201, stating that, despite noteworthy implementations, "there is no Islamic bank in the United States per se. That is, there is no stand-alone institution that is dedicated to shari'ah compliance and that provides a full range of banking services".

²⁴⁹ A model based on self-regulation nature of finance, the necessity to deregulation and innovate, etc. See **W.S. HEGAZY**, *Contemporary Islamic Finance: from Socioeconomic Idealism to Pure Legalism*, in *Chicago Journal of International Law* n. 7/2007, pp. 581-603; **S. GRISWOLD**, *A Redeeming Interest in Religious Freedom: Are Islamic Mortgage Alternatives Clogs on the Equitable Right of Redemption?*, in *Fordham Journal of Corporate and Financial Law*, n. 13/2008, p. 419; **H.A. HAMOUDI**, *Jurisprudential schizophrenia*, cit., p. 605.

²⁵⁰ **H. MASUD**, *Takaful: an Innovative*, cit., p. 1133.



Obviously, there are some inconsistencies between the abstract system and the real one.

Indeed, the majority of transactions in the Islamic financial world consist of the *murabaha* type and are usually short-term financings.

In so doing, these kinds of transactions do not correspond to the tenets of the Islamic doctrine but, on the contrary, they resemble those of conventional finance²⁵¹; then, as a consequence, genuine PLS are almost insignificant²⁵² and the Islamic finance comes to mirror the conventional finance²⁵³.

Reversing the perspective, conventional financial institutions must meet some specific requirements in order to comply with the *sharia* finance: the segregation of funds; the establishment of a *sharia* supervisory board; the presence of a management committed to Islamic financial concepts; a system of safeguards for investors; and the compliance with the standards of the AAOIFI²⁵⁴.

So, even if Islamic Finance has been a monopoly of local banks in Middle East and Malaysia, nowadays also non-Muslim institutions have begun to offer *sharia*-compliant services and this trend is now expected to grow²⁵⁵.

²⁵¹ O. AGHA, *Islamic Finance*, cit., pp. 125-135.

²⁵² Fund management transactions where the profit participation element is present are an exception (I. WARDE, *Islamic Finance*, cit., pp. 167-168).

²⁵³ The issue related to the imitation of the conventional financial system must be properly addressed since - given the monopoly played by the Wall Street model - the Islamic sector "appeared as one of the few structured systems of finance that offer some differences" (I. WARDE, *Islamic Finance*, cit., pp. 168-169).

²⁵⁴ K.J. TACY, *Islamic Finance: a Growing Industry in the United States*, in *North Carolina Banking Institute*, n. 10/2006, p. 369. See also S.N. YAQUBY, *Shari'ah Requirements for conventional banks*, available at http://www.islamic-banking.com/iarticle_7.aspx (last visited 21 November 2016), and A. MIRAKHOR, *Hopes for the Future of Islamic Finance*, in http://www.islamic-banking.com/iarticle_7.aspx (last visited 28 February 2018). It is important to note that, in any case, besides the kinds of banking operations described in the text as typically Islamic, there is the offer of a full spectrum of fee-paid retail services always interest-free, that include checking accounts, spot foreign exchange transactions, fund transfers, letters of credit, travellers' checks, safe-deposit boxes, securities safekeeping investment management and advice, and other normal services of modern banking. Islamic bank can also carry business with both Muslims and non-Muslims alike. See J.M. TAYLOR, *Islamic Banking - The Feasibility of Establishing an Islamic Bank in The United States*, in *American Business Law Journal*, n. 40/2003, pp. 385-414.

²⁵⁵ M.A. EL-GAMAL, *Islamic Finance*, cit., p. 108, offers a punctual representation of the role of the codified variant to Islamic law in the officially Islamized countries like Iran,



The most popular practice is the issuance of *sukuk* as it is testified by the examples reported by HSBC, Citigroup, Barclays Capital, Deutsche Bank, BNP Paribas, and Standard Charter²⁵⁶.

Trying to set out which contingencies could have contributed to this fast growth of Islamic Finance, it is possible to mention that *i)* *sharia*-compliant products are increasingly attractive to capital providers since the differential cost between traditional and Islamic products narrows; *ii)* the wealth of Muslim countries has increased thanks to high oil prices (therefore, Muslim investors have started looking for *sharia*-compliant options); *iii)* the regional lending capacity in Muslim-populated areas has raised; *iv)* large-scale development projects in the Gulf region have been launched which consequently have brought new lenders into that market; *v)* the availability of *sharia*-compliant products has been made easier; *vi)* finally, there has been a growing sense of religious identity among professional Muslims, who have been seeking new, tangible ways to express their values²⁵⁷; *vii)* overall, Islamic finance is slowly becoming more regulated and practiced both in countries where Muslims are the majority and even in those where Muslim minorities dominate the political and business environments²⁵⁸.

Among the challenges this growth has to face, one of the main problems for Islamic bankers is to be accepted by their own societies. In fact, even if this financial sector of started thanks to the investments of the oil

Pakistan and Sudan. These laws aim at “eradicate[ing] interest” and so “the financial systems in those States are therefore politically mandated to «interest-free»”.

²⁵⁶ T. KARASIK, F.C. WEHREY, S. STROM, *Islamic Business and Commercial Law: Islamic Finance in a Global Context: Opportunities and Challenges*, in *Chicago Journal of International Law*, n. 7/2007, pp. 385-386. Similarly, a number of large law firms have Islamic business departments or units (T. KARASIK, F.C. WEHREY, S. STROM, *Islamic Business*, cit., p. 386).

²⁵⁷ T. KARASIK, F.C. WEHREY, S. STROM, *Islamic Business*, cit., p. 386.

²⁵⁸ T. KARASIK, F.C. WEHREY, S. STROM, *Islamic Business*, cit., pp. 386-387. Yet, not all Muslim countries are switching to full-service Islamic financial institutions. The money market, equity, and hedge fund sectors are also vital to Islamic Finance, but they need to be adapted. Therefore, money market funds and bank accounts do not guarantee a fixed investment return; mutual funds do not invest in industries such as pork, gambling, entertainment, traditional financial services, and defence/weapons or in companies that are excessively leveraged. These limitations allowed, in any case, a great number of companies available for investment as it is shown by the Dow Jones Islamic Market Index that up to June 2006 listed 1,937 companies eligible for investment; hedge funds consistent with *sharia* started with the Saudi Economic and Development Company (SEDCO) in the fall of 2003. Finally, in 2007, the People's Republic of China launched its first Islamic bond with a \$ 200 million deal with Kuwait Finance House for a Chinese power company.



companies, its further development could be driven by the needs of the middle class: from the purchase of new houses to small business loans, from the building of a retirement plan to personal investments²⁵⁹.

Islamic finance has always been a fluid blend of business, politics, and religion, adapting to cultural differences and changing tastes. This tradition of flexibility and ingenuity will become increasingly indispensable as Islamic finance grows to reflect the diversity and vitality of Muslims around the globe²⁶⁰.

In other words, there is no one size fits all approach to Islamic retail finance as each one must be tailored to the local environment in which it operates²⁶¹.

However, such fragmentation and flexibility could also be a strength since they could allow for the development of new international regimes and alliances with both Muslims and non-Muslims.²⁶²

²⁵⁹ **R.R. BIANCHI**, *The Revolution in Islamic Finance*, in *Chicago Journal of International Law*, n. 7/2007, pp. 569-580.

²⁶⁰ **R.R. BIANCHI**, *The Revolution*, cit., pp. 569-580.

²⁶¹ **K. BALZ**, *Islamic Finance*, pp. 560-561. **G. JEHLE**, *Innovation, Arbitrage*, cit., pp. 1365-66, underlines that also a different process steps out leading to the creation of a sort of an Islamic *lex mercatoria*. In fact, "uncertainty and fragmentation among conflicting interpretations of *Shari'ah* by SSBs and other experts is currently being resolved [...] contributing to the emergence of an increasingly coherent body of transnational Islamic finance law. [...] a process of organic convergence is beginning to take place, under which the accepted trade practices of IFIs, given legitimacy by the *fatawa* of SSBs and other scholars, has led to a degree of consensus and consistency in some areas of practice". The Author clearly adds that "[t]his gradual crystallization of nonstate-driven norms drawn from standard business practices, soft-law codes, nonbinding standards such as the AAOIFI Principles, and opinions of loosely affiliated experts (such as SRBs and OIC *Shari'ah* scholars), exemplifies what has come to be known as transnational law. [...] [T]he Islamic finance law that is emerging from standardized industry practices, the work of *Shari'ah* scholars, and nonbinding standards such as the AAOIFI Principles is largely generated without intervention from any state but is able to affect compliance from participants in the Islamic finance industry across the globe. Just as multinational corporations may be driven to comply with corporate social responsibility codes for fear of the reputational consequences of noncompliance, IFIs and other participants in the Islamic finance industry have a strong incentive to comply with the generally accepted principles of transnational Islamic finance law for fear that their actions might be perceived as un-Islamic and thus rejected by consumers, investors, or other stakeholders".

²⁶² **R.R. BIANCHI**, *The Revolution*, cit., pp. 569-580. **E. GROSSMAN**, *The Human*, cit., p. 1034, maintains that "[e]ven if one begins from a starting point where the Qur'an is undeniably divine, it is difficult to ignore the patently human aspects of these *hiyal* [...] Functionalism [...] allows for the irruption of humanity's subjective value judgments into a space where divine or rigid rules would (or should) otherwise apply. It is thus difficult



to harmonize functionalism with a vision of Islamic jurisprudence that requires top-down legislation and adjudication guided by the original Qur'anic source-text". This dissonance could be reconciled maintaining that the true words of God are by their very nature unknowable. Therefore, "[...] It could follow, then, that if there is brooding, omnipresent, and true Shari'a law out in the ether, then the process of Islamic lawmaking is the profoundly human act of distilling it down to a cognizable form. In other words, the purpose of the commandment or prohibition becomes more important than the modes and forms of the actual doing or the actual withholding." **C. ARJONA, G. JEHLE**, *Islamic Law*, cit., p. 255, "[a]s is the case with most other legal traditions, the long history of Islamic law can be seen as a balance between rigidity and stability, on the one hand, and openness and dynamism, on the other. In this way, contemporary debates over Islamic finance are part of a longstanding contest between purists and pragmatists over the permissible mechanisms through which the law should be adapted to meet changed political, economic, and social conditions, as well as the limits of such adaptation. The development of the Islamic finance industry is a testament to the influence of Islamic revivalist thinkers who envisioned a new form of Islamic economics that would challenge both the capitalist and communist economic orders. However, rather than engaging in a radical rethinking of the methodology of Islamic law, Islamic finance scholars drew upon traditional tools of Islamic jurisprudence to make their legal arguments. The development of the Islamic finance industry thus displays both the historical continuity and the dynamism of Shari'ah as a legal system". See, also, **H.P. GLENN**, *Legal Traditions of the World*, Oxford University Press, 2014, pp. 213-14. Contemporary Islamic finance is pervaded by doctrinal pluralism and is adopting less stringent opinions from different schools to structure complex transactions. This tendency has been depicted as an ad hoc approach to jurisprudence, or as talfiq (patching). See **H.A. HAMOUDI**, *The Muezzin's Call and the Dow Jones Bell: On the Necessity of Realism in the Study of Islamic Law*, in *American Journal of Comparative Law*, 56/ /2008, pp. 423, 443-45. But as a legal doctrine has recently written: "[i]n pre-modern legal writing the use of a less stringent opinion, either within a particular school or across school lines, for a particular transaction was generally known as tatabbu" al-rukhas (pursuing the dispensations of the schools). A legal subject could achieve this by seeking advice in the form of a non-binding opinion (fatwa) from a scholar of a school different from that which the subject typically uses. A judge could also refer a case for resolution to a judge of another school according to the less stringent opinion. In modern discourse, the term tatabbu" al-rukhas was gradually replaced by takhayyur (eclecticism). In contrast with tatabbu" al-rukhas/takhayyur, which involve the choice of a less stringent opinion and its application to the entire transaction, the practice of talfiq involves the application of multiple legal opinions within the same transaction (or two back-to-back transactions) to achieve a result that would be accepted by no school, hence its name, which implies patching or stitching together". **C. ARJONA, G. JEHLE**, *Islamic Law*, cit., p. 255. All of these choice of law concepts, defined as "pragmatic eclecticism" represent technique according to which pre-modern scholars resorted to the doctrinal pluralism of the law in order to realize a given economic or social aim within the borders of taqlid. **C. ARJONA, G. JEHLE**, *Islamic Law*, cit., p. 264. So, "[m]odern Islamic finance scholars have followed the Majallah's methodology of "utilitarian choice" (takhayyur) by freely choosing among the opinions of the classical jurists based on what they believe is in the best interest of the community". **C. ARJONA, G. JEHLE**, *Islamic Law*, cit., p. 267. To this end, according to Arjona and Jehle, "the most productive approach for contemporary Islamic finance lawyers would be to look



15 - Conclusions

The legal systems taken into account throughout this article have deep-rooted differences: some are based on civil codes; some put their faith in precedents, while others have developed from religious texts.

The diversity among the declamatory provisions within the different systems seems to mirror the distance that separates them. As a result, one would expect opposite operational solutions, reflecting such diversity.

However, the financial systems of Islamic and Western economies, surprisingly, share more than a similar initial development: the common strict prohibition of lending money at interest was then followed by the creation of legal fictions or *fictiones* to lighten such restriction²⁶³.

Over time, Western economies have progressively stopped considering such activity as absolutely negative. On the contrary, they began to see it as a possibility for the development of their industrial and commercial activities. Once lending at interest ceased to be prohibited and consequently loans were finally considered legal, the use of fictions became meaningless.

In common law countries in particular, the spread of the *laissez-faire* doctrine, according to which the State does not have to regulate private transactions by means of imperative rules, freed interest rates from statutory limits.

Notwithstanding some positive implications related to this theory, its uncontrolled application has led, in recent years, to the degeneration represented, among others, by the payday loan phenomenon.

to the idea of *maslahah*, or communal welfare, both in determining the scope of permissible doctrinal pluralism and in weighing the legitimacy of using *hiyal*-like strategies in planning Islamic financial transactions". C. ARJONA, G. JEHLE, *Islamic Law*, cit., p. 270. *Maslahah* represents the spiritual benefit gained by the believer in complying with God's law, the underlying benefit to humanity that forms the basis of the ruling, "In this way, existing rulings may be adapted to suit changed circumstances if they no longer benefit the community. It is this conception of *maslahah* that offers the greatest potential for change and adaptation for Islamic finance practitioners". C. ARJONA, G. JEHLE, *Islamic Law*, cit., p. 271.

²⁶³ It is possible to summarize the historical evolution of the idea of *interest* and *usury* into the following three stages: a) a first stage in which it was generally forbidden (ancient times); b) a second stage in which a small rate of interest was permitted, but it was strongly regulated and limited from the State; c) a third stage in which it was thought that existing prohibitions on interest were wrongful and they should have been either decreased or removed altogether.



On the opposite side, the late industrial and economic growth of *sharia* led countries postponed, their need to create means to circumvent or eliminate the *riba* prohibition²⁶⁴.

As a result, even by means of the aforementioned fictions, which are essential to survive in the modern economy as well as to offer all the services that people need, those States currently retain such strong limitations with regard to financial operations, which, though, have partially protected them from the damage caused by the global financial crisis, while offering good perspectives to quickly overcome it.

²⁶⁴ Official 'Islamized' States, such as Iran, Pakistan and Sudan, produce a codified variant of Islamic law that plays a central role in the legitimacy of the ruling regimes. These laws constitute the first position in the hierarchy of Islamic law. In the area of finance, for example, this completely Islamized way of thinking is very explicit in Pakistan, where in the past two decades there have been a great number of banking laws, all aiming to eradicate interest. See **M.A. EL-GAMAL**, *Interest and the Paradox of Contemporary Islamic Law and Finance*, in *Islamic banking and finance*, edited by A. Al-Roubaie and S. Alvi, Routledge, London, 2003, p. 2. The second hierarchical level of Islamic law is represented by the Islamic law of Muslim States, which have actual civil codes declaring Islamic law as their source of legislation. An example is the Article 2 of the Egyptian Constitution, amended in May 1980, later strengthened through the following Egyptian Constitutional Court's ruling: "It is therefore not permitted that a legislative text contradicts those rules of *sharia* whose origin and interpretation are definitive, since these rules are the only ones regarding which new interpretive effort (*ijtihad*) is impossible, as they represent, in Islamic *sharia*, the supreme principles and fixed foundations that admit neither allegorical interpretation, nor modification. In addition, we should not contemplate that their meaning would change with changes in time and place, from which it follows that they are impermeable to any amendment, and that it is not permitted to go beyond them or change their meaning. The authority of the High Constitutional Court in this regard is limited to safeguarding their implementation and overruling any other legal rule that contradicts them" (see **S. HABACHY**, *Commentary on the Decision of the Supreme Court of Egypt Given on 4 May 1985 Concerning the Legitimacy of Interest and the Constitutionality of Article 226 of the New Egyptian Civil Code of 1948*, in *Arab Law Quarterly*, n. 1/1985-1986, p. 239. The third level of the hierarchy mentioned above concerns Islamic law pronouncements made by some important institutes such as: The Institute of Islamic Research at Al-Azhar University, established in Cairo in 1961; The Islamic Jurisprudence Institute of the Islamic League, established in Mecca in 1979; The Fiqh Institute or Academy of the Organization of Islamic conference, established in 1984 with a home in Jeddah, Saudi Arabia. The members of these institutes are appointed by their respective governments. A fourth category, defined 'Islamic law', adds another level of complexity to Islamic finance. This category has been endorsed by popular jurists who frequently rely on medieval literature in Islamic jurisprudence and frequently quote canonical texts to support these earlier opinions. The influence of these jurists has increased exponentially in recent years. See **M.A. EL-GAMAL**, *Islamic Finance*, cit.



Islamic financial instruments could represent the core of a less vulnerable financial model, founded on ethical principles meant to protect the single citizens from abuses and inequalities, and to prevent the banks themselves from triggering a systemic collapse.²⁶⁵

²⁶⁵ **A. FUCCILLO, F. SORVILLO**, *Religious freedom*, cit., p. 18 highlight that “[t]he general objectives in particular render the Ethical Bank’s ultimate goals real in the sense that it addresses mainly the financing of categories of persons “not” or “hardly bankable”, suggesting, in this way, more control of consumption and more attention to the use of savings by directing them towards nobler, social uses, on the basis of choices characterized by high “rates” of moral integrity. More examples could be provided. Just think of the use of microcredit as a tool for promoting financial inclusion of marginalized segments of the population, or of the forms of fair trade actually carried out in developing countries in the South of the world by way of production processes based on respect for hard work and natural resources, in order to provide, at the same time, the countries and markets in the North with new products that meet the demands for quality (and price) of “ethically oriented” consumers, thus helping to translate into reality paths of sustainable globalization. All these examples serve to emphasize that the relationship between financial and religious factors, far from being a theoretical invention, represent an actual reality that has a development potential not yet well explored although sometimes already tested as in the case of “cooperative” labour.” **M. GRADOLI, M. DEL CARMEN DE LA ORDEN DE LA CRUZ, P. SÁNCHEZ GONZÁLEZ**, *Vie d’inclusione dei musulmani in Europa: marketing halal e banca islamica*, in *Stato, Chiese e pluralismo confessionale*, n. 24/2016, available at www.statoechiese.it (last visited 21 January 2019), pp. 28-29, underlines how the Islamic Bank is an instrument apt to facilitate the financial inclusion. **L. ANDERLONI, B. BAYOT, P. BLEDOWSKI, M. IWANICZ-DROZDOWSKA, E. KEMPSON**, *Financial services provision and prevention of financial exclusion*, European Commission, Bruxelles, 2008, p. 10, define Financial inclusion as “[t]he perfect financial inclusion may therefore be described by the capacity to access and use appropriate financial services proposed by mainstream providers. Meanwhile, there may be an adequate “second best choice” to get appropriate services proposed by alternative providers that comply with rules and regulations and do not exploit low-income people. At least, an authenticated “social / open minded” provider may give a sufficiently safe / positive image to enable excluded people to try once again financial services, which could then be the first step towards financial inclusion with mainstream financial providers”. See, also, **S.B. NACEUR, A. BARAJAS, A. MASSARA**, *Can Islamic Banking Increase Financial Inclusion?*, IMF Working Paper, WP/15/31, 2015; **M. MOHIELDIN, Z. IQBAL, A.M. ROSTOM, X. FU**, *The role of Islamic finance in enhancing financial inclusion*, in *Organization of Islamic Cooperation (OIC) countries in Islamic Economic Studies*, 20/2012, pp. 55-120. Of course, “religion can act as a barrier to use – especially in Muslim populations” and “religious factors deter people from opening savings accounts just as they deter them from using credit”: **L. ANDERLONI, B. BAYOT, P. BLEDOWSKI, M. IWANICZ-DROZDOWSKA, E. KEMPSON**, *Financial services*, cit., p. 42. See **E. KEMPSON**, *Saving in Low-income and Ethnic Minority Households*, Personal Investment Authority, London, 1999; **S. COLLARD, E. KEMPSON, C. WHYLEY**, *Tackling Financial Exclusion: An Area-based Approach*, Policy Press, Bristol, 2001; and **S. COLLARD, E. KEMPSON**, *Affordable Credit: The Way Forward*, Joseph Rowntree Foundation, York, 2005.



In any case, the differences among the legal instruments created by the different legal traditions to rule the aforementioned issue reveal the fundamental diversity of mind regarding the role of law and its interpretation²⁶⁶.

A survey on the rationales and the legal justifications grounding these differences can be very productive if carried out for the purpose of out developing a dialogue among the different cultures and traditions; the discovery of shared principle and outcomes between *shari'ah* and Western legal traditions can be a useful tool to build a bridge between them²⁶⁷.

From a free market point of view, juxtaposing the words *ethic*²⁶⁸ and *finance* seems ironic, especially after having identified the cause of the global financial crisis itself: the hazard of certain institutions and of their managers, guided only by profit without paying adequate attention to the consequences of their behavior (for instance, the dramatic consequences of sub-prime loans, the abuse of derivatives, etc.)²⁶⁹.

²⁶⁶ M.H. LUBETSKY, *Losing Interest*, cit., p. 238, interprets the relatively permissive approach to interest-avoiding transactions as reflecting "a formalist approach to legal interpretation and an essentially ordering vocation of law". But, also the Western legal tradition has gone through its formalist periods and some aspects are still visible today.

²⁶⁷ M.H. LUBETSKY, *Losing Interest*, cit., p. 238. This comparison is useful not just to identify the similarities but also to better understand the causes of difference.

²⁶⁸ See U.F. MOGHUL, A.A. AHMED, *Contractual Forms in Islamic Finance Law and Islamic Inv. Co. of The Gulf (Bahamas) Ltd. V. Symphony Gems N.V. & Ors.: a First Impression of Islamic Finance*, in *Fordham International Law Journal*, n. 27/2003, pp. 150-156, who clearly underline that Islamic finance remains closely tied to the Islamic religion and, so, from a modern finance perspective, the main issue in dealing with Islamic finance is understanding "what it means for finance to be based in religion". On the Islamic side, instead, the task is to tailor fourteen centuries of legal scholarship in a new dress (twenty years old) and with a fashion "completely alien" to it (U.F. MOGHUL, A.A. AHMED, *Contractual Forms*, cit., p. 157).

²⁶⁹ M. d'ARIENZO, *I fondamenti religiosi della finanza islamica in Stato, Chiese e pluralismo confessionale*, n. 25/2012, available at www.statoechiese.it (last visited 21 January 2019), pp. 6-7 underlines that ethic and Islamic finance are both inspired not only by efficiency, competition, or profit maximization goals but are based on social cooperation. To this end, this becomes the epiphany of a social responsible finance. It is worthy of mention the fact that ethical finance was born at the beginning of the twentieth century in USA to satisfy the needs of religious movements. See, G.M. PICCINELLI, *Economia e banche tra Islam e Occidente*, in *Iura Orientalia II* (2006), pp. 128-134 (www.iuraorientalia.net). In this respect, the principles inspired by the religious ethic such as social responsibility, equity, and solidarity constitute a concrete alternative to the profit maximization that normally characterizes the traditional financial market. In other words, the same Author concludes suggesting a recovery of an "economic ethic" to achieve an opener global society, but above all a fairer one. M. d'ARIENZO, *I fondamenti religiosi*, cit., pp. 8-9.



Consumers have gradually lost their faith in banking institutions, indicated as the source of the crisis and so, of all their problems. Besides, certain categories of persons would never step into a traditional bank as a consequence of their religious or ethical beliefs. These two aspects may lead to a dangerous capital immobility, especially in those Western countries where the presence of Muslim immigrants, bound by the *riba* prohibition, is growing year after year²⁷⁰.

Shari'a-compliant financial institutions - characterized by a slightly stronger consumer protection and based on ethical principles - can be seen as a possibility to attract new potential investors and to move the huge amount of liquid assets present in the Gulf zone to the Western area. A wider circulation of capital and a rediscovered faith in the act of investing and in the banks themselves - together with the fact that an alternative model exists and is available - could represent a key solution to overcome the global financial crisis²⁷¹.

²⁷⁰ **B. SABAHI**, *Islamic Financial Structures as Alternatives to International Loan Agreements: Challenges for U.S. Financial Institutions*, in *Annual Review of Banking and Financial Law*, n. 24/2005, p. 487, says that to non-Muslims, the Islamic finance system (based on contractual structures in which the financier participates with the borrowers in the project, or enters into trade with them, and cannot totally isolate itself from the operation's risks) is an unconventional method of conducting business, according to the Author, it is predictable that the use of *sharia*-compliant modes of financing by U.S. banks will increase in the future (many large U.S. financial institutions, have already established Islamic financing units). Specifically, in this system, the banks can break down the barriers of operations that they traditionally do not undertake, such as project management. This kind of system, in addition, is not furnished with the standard safeguards against loss, such as default mechanisms and security interests in project assets, since they are not available in Islamic financing contracts (**B. SABAHI**, *Islamic Financial Structures*, cit., p. 503). See also **G.M. PICCINELLI**, *La Finanza islamica tra crisi globale e innovazione: la prospettiva europea*, in *Il Libro e La Bilancia. Studi in memoria di Francesco Castro*, edited by M. Papa, G.M. Piccinelli, D. Scolart, Edizioni Scientifiche Italiane, Naples, 2010, p. 977.

²⁷¹ **C. BEYER RICHINS**, *Shari'ah Compliant Securities: American Lawyers Meet Islamic Finance*, in *Journal of Legal Profession*, n. 33/2008, p. 135, suggests that lawyers dealing with Islamic counterparts by complying with Islamic finance principles will not only fulfil their ethical obligations, but also protect their clients' reputations and minimize unnecessary risk. **G. GORDON, D. ZARING**, *Ethical Bankers*, in *Journal of Corporation Law*, n. 42/2017, p. 559, "[e]thics represent a next step in a broad-reaching effort to recreate credible financial standards in the wake of the financial crisis, and one fascinatingly different from the prior efforts. Post-crisis reform has been many things, but one unifying principle has been the effort to develop highly detailed and very quantitative measures of the positions and resources of financial institutions. There is nothing quantitative or detailed about the effort to impose ethics on banks".



Even if we cannot simply transplant the Islamic model into Western legislation²⁷², its vicinity to ethical finance and its positive effects on capital movement make it an interesting archetype for reforms *de iure condendo*²⁷³.

In conclusion, if three decades ago, many saw Islamic finance as an oxymoron²⁷⁴, today, Islamic banking and finance no longer represent an uncertain experiment²⁷⁵.

But there is more, in fact it is possible to assert that there are no significant barriers today to the reception of these models in the West, as

²⁷² The issues related to credit, interest rate, and the relationship between debtor and creditor are well regulated by all the legal systems and the rules promulgated to facilitate the lending prevail over the restrictive regulations. M. H. Lubetsky with a vivid image concluded that: "These mechanisms produce largely the same results - Alex gets his loan, Ahmed his *bai' bithaman ajil*, Abraham his *heter iska*". **M.H. LUBETSKY**, *Losing Interest*, cit., p. 238. **H.A. HAMOUDI**, *The Impossible, Highly Desired Islamic Bank*, in *Willam and Mary Business Law Review*, n. 5/2014, p. 109, concluded that "[t]here is no credible *shari'a* compliant banking institution to facilitate. Instead, there are only compromises to be made, inevitably on the side of the Islamic bank, and plain *shari'a* violations to endure". But, the same Author continues saying that: "[t]he pious Muslim, eager to see an Islamic bank open in her neighborhood, earn a national charter, and offer products and services, including demand deposit services, is at best only partly interested in adherence to religious doctrine. At the very least, with the slightest bit of inspection, that Muslim will surely discover practices at stark variance with some of the core rules of Islamic finance and almost in direct opposition to the purported principles of the practice. Yet, the Muslim remains eager because the Islamic bank is a reflection of a broader recognition of her space in the broader American fabric. Her religion is not only recognized, but her financial practices are respected and indeed legitimized by the relevant American legal and regulatory regime. She is, in this sense, comfortable being both thoroughly American and thoroughly Muslim" (**H.A. HAMOUDI**, *The Impossible*, cit., p. 110).

²⁷³ **C.F. RICHARDSON**, *Islamic Finance Opportunities in the Oil and Gas Sector: An Introduction to an Emerging Field*, in *Texas International Law Journal*, n. 42/2006, p. 119, clearly represents the oil sector industry like a good example of this perspective. In fact, in States like Texas and Louisiana, «state law holds that the working interest in a mineral lease gives the holder a real property interest in the mineral estate (and, furthermore, holds that the mineral estate is actually the "dominant estate" in the property)». Another industrial area of possible eligibility is seen in the field of renewable energy where the interaction between the socially responsible projects and Islamic investing is clearer.

The Author quotes the example of an Italian developer who considered Islamic finance techniques to finance the development of wind farms. This tendency could play a role in the cross-border commercial and economic cooperation with the Islamic world.

²⁷⁴ **S.R. ANDERSON**, *Recent Development*, cit., p. 237.

²⁷⁵ **R. SIDDIQUI**, *Shari'ah Compliance, Performance, and Conversion: the Case of the Dow Jones Islamic Market Index*, in *Chicago Journal of International Law*, n. 7/2007, p. 495.



demonstrated by the experiences already underway, although with varying degrees of success in results and attitudes²⁷⁶.

²⁷⁶ A more thorough study of these issues will be the subject of a future essay, while a concrete analysis of how an Islamic bank could be established (in Italy) and how these contracts could be drafted belongs in a monographic study. But, it is worth mentioning a possible taxonomy. See, in this regard, **P. LEE**, *The Regulation of Securities and Islamic Finance in Dubai: Implications for Models of Shari'ah Compliance*, in *UCLA Journal of Islamic and Near Eastern Law*, n. 15/2016, p. 14, distinguishes among three different regulatory systems (Dubai DIFC, Malaysia, and the U.S. and U.K.) naming them 1) systems-based model; 2) centralized model; 3) a model of competitive equality, derived in part from an International Organization of Securities Commissions (IOSCO) report on Islamic securities. The term systems-based model indicates an approach where there is not, "and a regulator in a pure systems-based model would not, have a means of issuing its own *fatāw*; on Islamic financial activities. Instead, this responsibility falls to the Shari'ah Supervisor Boards at the level of the various entities involved in an activity or transaction. As may be evident, this paper takes the DIFC as a prototype for the systems-based model. [...] the term centralized model is used to describe an approach involving the presence of a single authority that can make a substantive determination on whether a particular financial activity or instrument is Shari'ah-compliant. For instance, in Malaysia. Finally, the model of competitive equality is used to describe approaches in Western jurisdictions that lack a separate regulatory system for Islamic finance, instead aiming for equal treatment of Islamic finance and conventional finance". Another classifications distinguishes among five models: "(1) a reactive approach in the U.K. and Turkey; (2) a passive approach, indicating the complete absence of a regulatory response, unique to Saudi Arabia; (3) a minimalist approach in the other GCC countries; (4) a pro-active approach in Malaysia; and (5) an interventionist approach, referring to the ability of the Pakistani Shari'ah Federal Court to make final rulings on Shari'ah matters despite the establishment of a national Shari'ah board at the State Bank of Pakistan" (**Z. HASAN**, *Regulatory Framework of Shari'ah Governance System in Malaysia, GCC Countries and the U.K.*, in *Kyoto Bulletin of Islamic Area Studies*, n. 3/2009, pp. 83-84).

Then, IOSCO, *Analysis of the Application of IOSCO's Objectives and Principles of Securities Regulation for Islamic Securities Products*, n. 17/2008, available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD280.pdf>, distinguishes 1) a systems approach; 2) a centralized approach; 3) a conventional approach; 4) other. The concept of 'competitive equality' is taken from the U.S. Bank regulation; here regulation states at the principle that state-chartered and federally-chartered banks should have equal competitive footing. See, e.g., **D.R. FISCHER**, **A.M. ROSENFELD**, **R.S. STILLMAN**, *The Regulation of Banks and Bank Holding Companies*, in *Virginia Law Review*, n. 73/1987, pp. 335-337.